NAVAL POSTGRADUATE SCHOOL
Monterey, California

THESIS

THE INDONESIAN FINANCIAL CRISIS : CAUSES AND REMEDIES

by

Heru Sudarminto

June 2000

Thesis Advisor:	Douglas Moses
Associate Advisor:	James Fremgen

Approved for public release; distribution is unlimited.

REPORT DOCUMENTATION PAGE

Form Approved
OMB No. 0704-0188

1. AGENCY USE ONLY *(Leave blank)*	2. REPORT DATE	3. REPORT TYPE AND DATES COVERED
	June 2000	Master's Thesis

4. TITLE AND SUBTITLE : THE INDONESIAN FINANCIAL CRISIS : CAUSES AND REMEDIES

5. FUNDING NUMBERS

6. AUTHOR(S)
Heru Sudarminto

7. PERFORMING ORGANIZATION NAME(S) AND ADDRESS(ES)
Naval Postgraduate School
Monterey, CA 93943-5000

8. PERFORMING ORGANIZATION REPORT NUMBER

9. SPONSORING / MONITORING AGENCY NAME(S) AND ADDRESS(ES)

10. SPONSORING / MONITORING AGENCY REPORT NUMBER

11. SUPPLEMENTARY NOTES
The views expressed in this thesis are those of the author and do not reflect the official policy or position of the Department of Defense or the U.S. Government.

12a. DISTRIBUTION / AVAILABILITY STATEMENT
Approved for public release; distribution is unlimited.

12b. DISTRIBUTION CODE

13. ABSTRACT ***(maximum 200 words)***

In 1997 Indonesia experienced a severe financial crisis due to problems in its banking system. The central objective of this study is to analyze the Indonesian government's banking system policies, identify the causes of the financial crisis and analyze the government's efforts in response to the crisis. This thesis investigates the government's policies and its efforts in reviving the banking sector by using archival research, as well as a literature search of books, magazine articles, Internet articles, newspaper articles, and other library information sources. A program of recapitalization and restructurization of the banking system was a prime factor in the economic recovery in Indonesia. One lesson learned was that the central bank, as the monetary authority was not free from external pressure, especially from the government. As a result, policies were adopted to respond to immediate problems as they arose, without consideration of broader economic consequences, which in turn created other unforeseen problems. When a new Indonesian government rose to power, it improved the legal foundation of the monetary authority to make decisions, by clarifying its power and duties, and protecting it from external intervention or pressures. The monetary authority now has the independence and power to implement policies based on sound economic principles.

14. SUBJECT TERMS
Indonesian Financial Crisis in 1997

15. NUMBER OF PAGES
111

16. PRICE CODE

17. SECURITY CLASSIFICATION OF REPORT	18. SECURITY CLASSIFICATION OF THIS PAGE	19. SECURITY CLASSIFICATION OF ABSTRACT	20. LIMITATION OF ABSTRACT
Unclassified	Unclassified	Unclassified	UL

NSN 7540-01-280-5500

Standard Form 298 (Rev. 2-89)
Prescribed by ANSI Std. 239-18

THIS PAGE INTENTIONALLY LEFT BLANK

Approved for public release; distribution is unlimited

INDONESIAN FINANCIAL CRISIS: CAUSES AND REMEDIES

Heru Sudarminto
Captain, Indonesian Army
B.S., Indonesian Open University, 1995

Submitted in partial fulfillment of the
requirements for the degree of

MASTER OF SCIENCE IN MANAGEMENT

from the

NAVAL POSTGRADUATE SCHOOL
June 2000

Author: ______________________
Heru Sudarminto

Approved by: ______________________
Douglas. Moses, Thesis Advisor

____
James. Fremgen, Associate Advisor

____
Reuben T. Harris, Chairman
Department of Systems Management

THIS PAGE INTENTIONALLY BLANK

ABSTRACT

In 1997 Indonesia experienced a severe financial crisis due to problems in its banking system. The central objective of this study is to analyze the Indonesian government's banking system policies, identify the causes of the financial crisis and analyze the government's efforts in response to the crisis. This thesis investigates the government's policies and its efforts in reviving the banking sector by using archival research, as well as a literature search of books, magazine articles, Internet articles, newspaper articles, and other library information sources. A program of recapitalization and restructurization of the banking system was a prime factor in the economic recovery in Indonesia. One lesson learned was that the central bank, as the monetary authority was not free from external pressure, especially from the government. As a result, policies were adopted to respond to immediate problems as they arose without consideration of broader economic consequences, which in turn created other unforeseen problems. When a new Indonesian government rose to power, it improved the legal foundation of the monetary authority to make any decisions, by clarifying its power and duties, and protecting it from external intervention or pressures. The monetary authority now has the independence and power to implement based on sound economic principles.

THIS PAGE INTENTIONALLY LEFT BLANK

TABLE OF CONTENTS

ACKNOWLEDGMENT

I want to thank our principal advisor Prof. Doug Mosses and second reader Prof. James Fremgen for their great contribution to the quality of this work through their superb analytic, professional, and editing abilities. Their guidance and assistance during the writing of this thesis is greatly appreciated. We also want to thank Prof. Ron Rusell for his editorial assistance in completing this thesis.

Finally, the blessing and support I received from my family members were constant sources of inspiration. The love, affection, and support of my wife, drg. Adi Widyandini, who has borne the brunt of my aspirations in accomplishing this work and my daughter, Ruri also deserve recognition for their understanding and patience while I was working on this thesis.

I. INTRODUCTION

A. OVERVIEW

A major financial crisis in Asia spread to Indonesia in late 1997 and continued through the first half of 1998. The crisis in Indonesia was aggravated by internal factors, rooted in unsound banking practices. Large amount of offshore borrowings had been made and now had to be repaid at a time when the money supply (Foreign exchange reserves) was dwindling. Currency speculation and capital flight by Indonesian conglomerates led to an excessive devaluation of the currency. That devaluation, in turn, caused pervasive economic turmoil. Many large corporation shut down their production operations because the prices of raw materials had risen to prohibitive levels. The number of performing loans increased, millions of workers were laid off, and the overall quality of life deteriorated as the GDP per capita dropped sharply.

B. PURPOSE

The purpose of this thesis is to analyze the government's policies and its efforts to overcome and resolve the monetary and currency crisis that occurred in Indonesia in 1997, and to review the existing regulations on the banking sector that were considered to have contributed to these conditions. This study includes an analysis of the underlying causes of the monetary and currency crisis. These problems were both external and internal to Indonesia. Externally, the Indonesia financial crisis happened as a result of declining exports, especially when oil prices dropped, and a tremendous amount of uncontrolled of offshore short- term loans made by private sector. Internally, the

monetary authority was in a weak position in terms of its independence and clearly vulnerable to pressures, which resulted in poor supervision of the banking industry, inadequate enforcement of banking laws, and a lack of transparency due to banks not disclosing their financial condition. All these factors contributed to the financial crisis in Indonesia.

C. SCOPE AND METHODOLOGY

This thesis focuses on the analysis of the Indonesian government efforts in reviving the banking sector, and on its delegation of authority and responsibility to the IBRA to recapitalize and to restructure the banking system. The scope also includes a review and analysis of:

- Review and identify the development of the financial institutions in Indonesia.
- Review and identify the effects of the Asian financial crisis on Indonesia.
- Identify the weaknesses and distortions of the Indonesian Central Bank.
- Identify the weaknesses of the government regulation about the banking system.

The methodology used in this thesis consists of archival research, as well as a literature search of books, magazine articles, Internet articles, newspaper articles, and other library sources. All data and information are analyzed to draw conclusions.

C. ORGANIZATION OF STUDY

The following is a brief summary of the discussion in each of the chapters.

Chapter II gives an overview of the development financial institutions in Indonesia as a means of facilitating world trade. The financial institution in this emerging economy resulted in a volatile reaction to the Asian financial crisis.

Chapter III identifies the internal causes of the financial crisis in Indonesia and also gives a description of the role of the monetary authority and the effect of government intervention on the monetary authority.

Chapter IV gives a description of the government's efforts to overcome and to resolve the financial crisis by focusing on recapitalization and restructurization of the banking sector, on the legal foundation for the monetary authority, and on modifications made to the existing regulations on banking sector.

Chapter V presents an analysis of the government's banking policies in response to the financial crisis, especially in reviving the banking sector.

Finally, Chapter VI presents the conclusion and recommendations.

THIS PAGE INTENTIONALLY LEFT BLANK

II. BACKGROUND

This chapter will trace the development of the Indonesian financial institutions from 1967 to the financial crisis in Indonesia in 1997. The Indonesian government, as is common in developing countries, acted to accelerate and initiate the development of financial institutions. Since Indonesia has been adopting an open market policy, external factors and world trade patterns have influenced the development of the financial institutions. The Asian financial crisis has directly impacted the Indonesian economy, especially the banking sector. Indeed, the contagion effects of this crisis spread out widely in the region, including Indonesia. The last section of this chapter explains the Indonesian monetary authorities' efforts in managing and defending the nation's financial stability to halt the contagion effects.

A. DEVELOPMENT OF THE FINANCIAL INSTITUTIONS IN INDONESIA

During President Soekarno's administration, Bank Indonesia (BI) was merely a payment agency for the government and under the control of the President. When President Soeharto took over the government in 1967, Indonesia entered a new era of developing the banking system. To provide some autonomy for BI, President Soeharto enacted Law No. 13 of 1968, which dealt with the Central Bank. The BI, as the central bank, had a major responsibility for supervising banks and other credit-granting institutions, and for setting an appropriate legal structure for banks. (Cole & Slade, 1996, p.37)

The financial sector has dominated the economic activities in most countries, especially in developing countries such as Indonesia. The financial institution's performance can be used as a measure of a country's economic condition. The development of financial institutions in Indonesia can be categorized into four significant events:

- Opening the Jakarta Stock Exchange
- Establishing indirect monetary instruments
- Establishing Nonbank Financial Institutions (NBFIs)
- The Banking Law in 1992

1. Opening the Jakarta Stock Exchange

The government's primary concern in promoting the economic growth was that the private sector in the nation was far behind the state's enterprises. To encourage the private sector to grow, the government needed to be involved in solving their problems. It was determined that the private sector needed more funds to expand production. In order to raise funds from the public, the government issued a Presidential Decree in December 1976.

Basically, the Presidential Decree was intended to activate the Capital Market Executive Supervisory Agency (BAPEPAM). "BAPEPAM is a government agency with three responsibilities: to operate the stock exchange, to evaluate the documents of the companies proposing to raise funds from the public, and to carry out government policy." (Cole & Slade, 1996, p.153)

To carry out the mandates as instructed in the Presidential Decree, BAPEPAM was to establish an equity market or capital market. On August 10, 1977, BAPEPAM established the Jakarta Stock Exchange (JSE) with Semen Cibinong as the first listed company, issuing shares worth Rp. 1.8 billion. To promote and to advertise the JSE, BAPEPAM allowed all financial institutions, both domestic and foreign, to get involved in trading their shares. "Total share market capitalization grew from Rp.2.7 billion in 1977 to Rp. 482 billion at the end of 1988, and then to nearly Rp.104 trillion at the end 1994." (Cole & Slade, 1996, p.167)

BAPEPAM has been considerably constrained in its direct intervention. First, BAPEPAM issued the rules requiring preemptive rights, which means existing stockholders have the opportunity to purchase shares of a new issue before it is offered to others. Second, BAPEPAM recognized that stock exchanges are self-regulatory organizations. BAPEPAM must approve any changes in stock exchange rules in advance. Third, BAPEPAM also set the rules for allocating initial public offerings (IPOs) in an attempt to allocate shares to small domestic investors.

The Presidential Decree also created DANAREKSA as a state agent of economic development, which has a specific goal to spread the ownership of shares to small investors in Indonesia through investment funds. DANAREKSA was given privileged access to new issues of stocks and the right to set up investment funds, and it also served as a privileged underwriter, broker/dealer and investment funds manager. "DANAREKSA now is the holding company for three wholly owned subsidiaries:

DANAREKSA SECURITIES, DANAREKSA FUND MANAGEMENT, and DANAREKSA FINANCE." (Cole & Slade, 1996, p.217)

2. Developing Indirect Monetary Instruments

In accordance with the credit ceiling removal, the BI subsequently issued new money market securities, and the BI also became a buyer of bank-endorsed or bank-issued commercial paper, as well as a buyer and seller of foreign exchange through foreign-exchange-swap contracts.

The intent of the monetary policies was that SBPU (promissory notes issued by banks) and swaps (BI's facility in converting foreign currency into domestic currency) were used primarily as quantitative instruments of monetary policy designed to control the money supply. The SPBUs were not allowed to develop as a liquid financial instrument. The used of the SBPUs was rising during that period:

> The SBPUs were essentially a standardized banker's acceptance, which BI was prepared to purchase at a discount from the banks. The volume of SBPUs held by BI rose from $ 0.1 billion to $ 0.5 billion in 1983, indicating the amount of reserved money supplied to the banks by BI through this channel. (Cole & Slade, 1996, p.50).

The certificates of Bank Indonesia (SBI) initially had maturities of 30 and 90 days and were sold each week, ostensibly through an auction, but in fact at cut-off discount rates determined by the BI. The demand for SBI was low due to its yield, which was significantly lower than bank lending rates. There were no requirements for holding

liquid reserves. "The SBI, on the other hand, was a fixed interest rate instrument used for liquidity adjustment, primarily by the state banks." (Cole & Slade, 1996, p.51).

A third money market instrument used by BI during this period was the foreign exchange swap facility. "The BI set a swap premium at a uniform rate of 5.25 % per annum, which was less than the difference between the US Dollar LIBOR (London Interbank Offer Rate) and the domestic Rupiah deposit rates." (Cole & Slade, 1996, p.51) This resulted in strong demand for swaps and the BI responded by putting a ceiling on the amount of swaps it would enter into with each bank.

3. Establishment of Non-Bank Institutions (NBFIs)

To promote the money and capital markets, the Minister of Finance authorized the establishment of a new category of financial institutions, known as nonbank financial institutions (NBFIs). Since the indigenous Indonesians were not familiar with this type of entity, the government required each NBFI to be in the form of a joint venture with foreign partners. There were three categories of NBFIs:

a. Three Development Finance Corporations (DFCs). These entities dealt in medium and long-term financing and purchase equity.

b. Nine Investment Finance Corporations (IFCs). To serve as intermediaries and underwriters, which could help to develop long-term debt instruments.

c. Others, which would be regulated later on. There were two entities, which could be grouped in this category; PT. Papan Sejahtera and PT. Sarana Bersama Pembiayaan Indonesia. (Suyatno, Marala, & Abdullah & others, 1999, p. 13)

Considering their significant contributions toward competitive businesses and economic growth, the BI gave them the responsibility to serve as agents and market makers in the SBI/SBPU markets.

4. The New Banking Law in 1992

The Indonesian Government enacted the Act No. 7 of 1992 concerning the banking system. This Act was intended to provide a legal basis for regulating the banking industry, insurance, and private pension funds.

a. Banking Industry

The Banking Law provided for two categories of banks, General Banks and Peoples' Credit Banks (BPRs). These banks were described as stated in the Act No. 7 of 1992:

> General Banks were authorized to engage in most types of normal commercial banking businesses, although special authorization is required to engage in foreign exchange business, including taking deposits and making loans denominated in foreign exchange and trading in foreign exchange. Peoples' Credit Banks are basically small-scale savings banks. They are limited in term of location, functions, and portfolio composition. They are precluded from taking demand deposits and participating in the payment system. The main role of Peoples' Credit Banks is to take time and savings deposits and to extend credit. (Cole & Slade, 1996, 129)

These rural financial institutions at least made it possible to provide outlets for savings of rural people and to provide small or medium size loans.

To accommodate high demand from various Islamic organizations, the government, through the Act No. 7 of 1992, introduced the profit sharing bank. In their

view, based on their religion, interest resulting from depositing money in a bank is not allowed. But they could earn a profit if the bank was able to make profit by circulating the money into businesses. The term profit sharing is derived from the profit that a bank can make and then divide equally between the bank and the money owner.

Cole & Slade (1996) described the profit sharing bank:

> This type of bank, under the category of general bank, is subject to the same regulations as other general banks. Its operation in investment and other services is similar to those of ordinary commercial banks, but depositors are actually investors, who make a return only if the banks make a profit. The law recognizes that this financial return can be on the basis of a sale or purchase principle in accordance with Islamic law rather than on the basis of interest on financial investment. (Cole & Slade 1996, p.134)

b. Insurance Company

Historically, insurance companies have been operating since 1957, when the Indonesian Insurance Council or Dewan Asuransi Indonesia (DAI) was established. "In the early years, membership in DAI was compulsory and a recommendation by DAI was necessary to get a license from the Minister of Finance."(Cole & Slide, 1996, p 239) The DAI set insurance tariff levels, which then had to be approved by the Minister of Finance. The DAI also acted as arbitrator in disputes. "In 1968, the Minister of Finance tried to activate the private sector by removing the monopoly of the government on all objects of insurance, but in practice state institutions continued to buy insurance from state insurance firms." (Cole & Slide 1996, p. 239)

Eventually, foreign firms were permitted to engage in general insurance businesses in Indonesia, but they were required to handle reinsurance business in

Indonesia. Insurance activities began to grow more rapidly, as did the entire financial system. Life insurance in particular has shown a fivefold increase in assets over the period and has become an important player in several markets. (Cole & Slide 1996, p. 242)

c. Private Pension Funds

As part of raising the public funds to stimulate economic growth, the government authorized the establishment of private pension funds. Cole & Slade (1996) acknowledge:

> The Ministry's objectives in putting forward the pension law was: to establish the right of participants; to provide a regulatory standard, which would assure the ultimate receipt of pension benefits; to make certain that pension benefits were used as a source of continuing income for retirees and to provide proper governance for the pension funds; to encourage mobilization of saving in the form of long-term pension funds; to see that such funds were not retained and used by employers for possible risky or unsound investment, but instead would flow into the financial market and be subject to risk reducing requirements. (Cole & Slade, 1996, p.250)

Private pension programs have also been offered in various forms by employers through the years, but consisted almost exclusively of a lump-sum payment upon retirement. Most state-owned enterprises had their own pension funds. "By the end of November 1993, there were 521 licensed pension funds, of which 508 were employer-managed pension funds and 13 independent funds." (Cole & Slade, 1996, p. 261)

B. THE EAST ASIAN FINANCIAL CRISIS

The East Asian financial crisis that occurred in the second semester of 1997 to the second semester of 1998, was conspicuous in several ways. The crisis hit the most rapidly

growing economies in the world and damaged their fundamental economy badly. It was the sharpest financial crisis to hit the developing countries since the Mexican financial crisis. It was the largest financial bailout in history, since those countries were required to recapitalize and to restructure their financial institutions, especially in the banking sector.

In their research into the crisis, Radelet and Sach (1998) admit, "the basic diagnosis of the Asian financial crisis was that East Asia had exposed itself to financial chaos because its financial systems were riddled by insider dealing, corruption, and weak corporate governance, which in turn had caused inefficient investment spending and had weakened the stability of the banking system." (Radelet & Sach, 1998,p.1)

Most economic experts believed that the East Asian financial crisis occurred not only from the internal weaknesses, but also from the changes in the world trade pattern. "There were some explanations for the East Asian financial crises that could be identified, such as: (1) shifts in international market conditions; (2) growing weaknesses and mismanagement in the Asian economies; and (3) instabilities intrinsic in the international capital markets." (Radelet & Sach, 1998, p.1-18)

1. Shifts in International Market Conditions

International trade had a significant contribution to the East Asian crisis. Southeast Asian countries had lost their competitiveness with other countries. The following explanation from Radelet & Sach (1998, p. 19) gives the impression that cheap labor alone cannot ensure a continuing competitive advantage:

> There was a new global glut in labor-intensive manufactured exports, precisely the kind that fueled East Asia's growth in the past generation. This glut would be reflected in slower export earnings in labor-intensive countries and declining terms of trade for labor-intensive products, such as apparel, footwear, steel, and consumer electronics. World prices for manufactured exports fell about 2% in 1996 (IMF, 1997). Semiconductors were hit especially hard, when prices fell by as much as 80% in 1996 before beginning to rebound. (BIS, 1997).

The rapid growth in electronics production in East Asia, coupled with the addition of China and Mexico to these markets, created excess productive capacity and contributed to price declines. Price behavior follows the economic law that, if the supply of products increased sharply, ceteris paribus, the price of those products would be lower than before. In addition, some other countries were offering cheaper prices for similar products. The East Asian countries found that China, "the sleeping giant," has weakened their exports. Radelet & Sach (1998) confirmed the growing competitive pressure, especially from China:

> A further influence might have been that the economic rise of China may have dramatically shifted export-oriented production away from South East Asia. Increasing exports from $20 billion in 1986 to $150 billion in 1996 made China the eleventh largest exporter in the world. Chinese firms compete directly against other firms in the region in textiles, apparel, and electronics, and in other specialized products. China's share of garment exports surged from 37% in 1990 to 60% in 1996, and its share of electronics exports jumped from 12% to 18%. (Radelet & Sach, 1998, p.20)

The East Asian countries not only faced competition from inside their region, but also were influenced by other regions in the world as well. The increased interest rate in the U.S. over the European banks and the passage of NAFTA contributed to the declining exports of the East Asian countries. As Radelet & Sach assert:

> The passage of NAFTA and the dramatic surge of Mexico's exports may have resulted in intense new competition for East Asia. Mexico's total exports soared from $52 billion in 1993 to $96 billion in 1996, with gains in several areas that directly compete with East Asian countries. The sharp real appreciation of the U.S. dollar against the European currencies and the Yen after 1994 may also have played a role. Since all of the Southeast Asian currencies were effectively pegged to the dollar, each appreciated significantly against the yen as the yen/dollar rate moved from ¥/$ 85 in June 1995 to ¥/$ 127 in April 1997. (Radelet & Sach, 1998, p.20)

Probably each of these factors contributed to the export slowdown in 1996, which, in turn, raised concerns among Southeast Asia's creditors about the ability of firms in these countries to repay their debts.

2. Mismanagement in the Asian Economies

Many of the problems had their origins in the financial liberalization policy in the late 1980s and early 1990s that led to a quite rapid expansion of the financial sector and enthusiastic lending by foreign creditors. Entry requirements into financial services were loosened, allowing new private banks to open. Banks were given greater leeway in their lending decisions, and stock and bond markets began to grow and develop. Importantly, banks and financial institutions had new freedoms to raise funds offshore. This combination led to a rapid expansion in both offshore borrowing and domestic lending, with a resulting investment boom. In Thailand, Korea, and Malaysia, bank claims on the private sector increased by more than 50% relative to the GDP in just seven years. (Radelet & Sach, 1998, p.21)

Surprisingly, however, property prices showed almost no change between 1992 and the end of 1996. These prices fell sharply in early 1997, helping to set off the crisis.

"The combination of the rapid inflow of foreign capital, the appreciating real exchange rate, and the rapid growth in bank lending undoubtedly deteriorated the quality of investments in Asia." (Radelet & Sach, 1998, p. 22-24.)

The East Asian financial crisis was quite unpredictable. A few years prior to the crisis, most economic experts forecasted high economic growth for the East Asian countries. They called this phenomenon the "Asian Miracle." In the eyes of the investors, making investment in a country with high economic growth is more favorable. As a result, the East Asian countries became targets of foreign investors. Radelet & Sach (1998, p. 13), in the " *Onset of the East Asian Crisis,*" explained that the crisis was unpredicted.

> One reason that the crisis was largely unanticipated by international lenders and most market observers was that many of the signals that analysts normally associate with impending problems showed little sign of deterioration. Most fundamental aspects of macroeconomic management remained sound throughout the early 1990s. Government budgets registered regular surpluses in each country. While governments have been too enthusiastic in promoting large-scale Infrastructure investments financed by foreign inflows, and while there are no doubt important fiscal liabilities outside of the formal budget, all five countries maintained a fairly responsible budgetary position between 1990 and 1996. Partly as a result of this budgetary prudence, inflation rates have been below 10% across the region during the 1990s. Similarly, domestic savings and investment rates were very high throughout the region, suggesting that even if foreign capital flows slowed, robust growth could continue. Foreign exchange reserves at the end of 1996 were well over four months of imports in each country except South Korea, where they were equivalent to 2.8 months of imports. In Thailand, official figures suggest that reserves reached a seemingly very healthy $38.6 billion at the end of 1996, equivalent to over seven months of imports.

3. Instabilities in the International Capital Markets

The third possible explanation of the Asian financial crisis is that the crisis was triggered by dramatic swings in creditor expectations about the behavior of other creditors, thereby creating a self-fulfilling, though possibly individually rational, financial panic. Trade deficits and declining exports on one hand, and rising nonperforming loans and declining price in property sector on the other, made the fundamental economic condition vulnerable in these countries. Foreign investors realized that they would have a greater loss if they did not dump their domestic shares. As a consequence, capital flight occurred. Radelet & Sach (1998) described it.

> The net capital flows to the five East Asian countries were rising prior to the crisis. Private net inflows to these five countries soared, rising from \$40.5 billion in 1994 to \$92.8 billion in 1996. Suddenly, in 1997, the long period of inflow abruptly reversed, with a net outflow of around \$12.1 billion. A remarkable unexpected swing of capital outflow of \$105 billion represents around 11% of the pre-crisis dollar GDP of the five Asian countries. (Radelet & Sach, 1998, p.2)

The withdrawal of foreign funds triggered a chain reaction, which quickly developed into a financial panic. The exchange rate decline associated with the withdrawal itself sparked new withdrawals of foreign exchange, as domestic borrowers with unhedged currency positions rushed to buy dollars. Throughout Southeast Asia, few firms had hedged their exposure, since they believed that the government would retain a stable exchange rate. As the currency depreciated, foreign lenders became more concerned that their customers would be unable to repay their debts and began to call in their loans, reinforcing the decline. (Radelet & Sach, 1998, p.22)

The withdrawal of funds also set off a liquidity squeeze and a sharp rise in interest rates. As a result, firms that were profitable before the crisis found it difficult to obtain working capital or to remain profitable with significantly higher interest rates. The investor panic was triggered by the following explanations:

Offshore creditors became concerned about the profitability of their customers and grew increasingly reluctant to roll over short-term loans. The lack of clear bankruptcy laws and workout mechanisms added to the withdrawal of credit, since foreign lenders feared they would have little recourse to collect on bad loans. Non-performing loans rose quickly, and depositors withdrew their funds either out of concern over the safety of the banking system or in order to meet pressing foreign exchange obligations. The losses on foreign exchange exposure and the rise in non-performing loans eroded the capital base of the banks, adding to their stress. (Radelet & Sach, 1998, p.20)

According to the central hypothesis of financial market instability, a country with a high ratio of short-term debt to short-term assets (measured as the ratio of BIS short-term debt to the foreign exchange reserves of the central bank) would be more vulnerable to crisis.

C. THE IMPACT OF THE ASIAN CRISIS ON THE INDONESIAN BANKING SYSTEM

As currencies were falling in Southeast Asia, the Indonesian government was urged to take steps to halt the contagion effects. Although economic fundamentals remained strong in Indonesia, this fact did not mean that Indonesia was excluded from the

currency crisis. In order to defend the currency's stability and economic wealth, the Indonesian government asked for the IMF's assistance and tried to protect the Rupiah.

1. Protecting the Rupiah

The governor of the Bank Indonesia announced that devaluation of the Yuan (China's currency) and Bath (Thailand's currency) had a direct effect on the Rupiah, since Indonesia had too much offshore borrowing. About $43 billion of that would have to be repaid shortly, while the national reserves exchange was about $20 billion. This shortage of the supply of dollars would not satisfy the demand and was causing creditors to panic. "In addition, the IMF warned the Indonesian government that there were serious and growing weaknesses in the banking sectors."(Mann, 1998, p. 16)

To protect the Rupiah, the government, supported by the IMF, was urged to widen the band for the Rupiah from 8% to 12% and then to float the rupiah and abandon the band completely with the rupiah at 2,755 to the US Dollar. The government also was raising interest rates over 50%. Commercial banks were allowed to reduce their foreign reserves from 5% to 3% in order to increase the supply of dollars. An attempt was made to further increase the supply of the US dollar by opening up swap facilities to exporters. The reason behind this was to absorb the current supply of money by encouraging people to save their money in banks and to reduce the conversion of rupiahs into dollars.

To calm the nervous creditors and to boost confidence, restrictions on foreign share ownership, previously set at a maximum of 49%, except for banking and securities, were removed. The government also announced that public sector projects would be

reviewed with a view to postponement, especially those with high import content. There were 15 major development projects worth more than $34 billion. "Most of the projects were in the sectors of energy, mining, transport and public works, and even included certain luxurious projects for the President's family." (Mann, 1998, p.41) The next day the Rupiah remained stable and stock prices strengthened. First deputy Managing Director of the IMF, Stanley Fischer, was quoted as saying, "The IMF has been impressed by the fact that Indonesia has moved decisively in the foreign exchange market, on the budget and on structural measures in economy." (Mann, 1998, p. 40)

2. Market Failure or Banking Failure?

Two months later, Indonesia's private sector was already complaining from the hardship inflicted by persistently high interest rates. Debt burden was higher because of high interest rates, and debt repayment was more difficult because of declining sales revenue. The demand for property declined as the seller increased the price. Mann (1998) emphasized this situation:

> As interest rates rose, less and less property could be sold. So more and more developers faced difficulties servicing and repaying the short-term loans they had made to develop property. Throughout the last quarter of 1997, property sales plummeted, chronic oversupply set in, and developers faced bankruptcy. (Mann, 1998, p. 31)

Share prices continued to tumble as the market saw companies getting into deep difficulties as a result of the interest rates being used to protect the currency.

Rising interest rates forced private commercial banks to maintain their competitiveness by offering interest rates far above those of state banks to attract

depositors. The banking system quickly came under intense pressure. Lending rates fell steeply. Many companies had loans from the private banks and continued to suffer from punishing interest rates. Of course, new borrowers could not dream of asking for loans from private banks, thus contributing to the drying up of loans. Also depositors now wanted to be quite sure that their money was safe, since depositors had no information about safety. Non-performing loans were soaring as more companies tumbled into bankruptcy. By late October, the problem of liquidity had become acute. Mann (1998) admits:

> There were rumors that the IMF was asking to close 50 banks, including the reliable Jakarta Foreign Banking Sources, which was listed as number 42. It was hard to see how this would reassure creditors or investors or even the market. On October 31, sixteen of those banks were closed and 9,000 employees were laid off with only three months severance pay. The Minister of Finance confirmed that bad debts meant that all the banks had more liabilities than assets. The terminated banks were Harapan Sentosa, Andromeda, Pacific, Astria Raya, Guna International, Dwipa Semesta, Kosagraha Semesta, Industri, Jakarta, Citrahasta, South East Asia, Mataram Dhanata, Pinaesan, Anrico, Umum Majapahit, and Sejahtera Bank Umum. Several of the closed banks were run by politically connected business figures. On the day bank closure was announced, the stock market again fell and the rupiah was described as dithering at Rp. 3,625 to the US dollar. (Mann, 1998, p. 53)

3. Poison Pills from IMF

The combination of high interest rates and a constantly devaluing currency were inflicting great damage on the economy and were further revealing critical weaknesses in the way most business was done in Indonesia. Layoffs were already taking place, and projects and production were scaled back. The rupiah continued its fall, reaching Rp. 6,000 to the US dollar a few days before the Christmas holiday. (Mann, 1998, p.87)

In addition, Indonesian export trade found a new barrier; most foreign banks refused letters of credit issued by Indonesian Companies. "Bisnis Indonesia" reported that not only Japanese banks but also all foreign banks would only accept "sight LCs" from Indonesia, in other words, no cash, no goods. If Indonesia's export trade halted, a major still-viable source of foreign exchange would dry up, threatening not only the national economy but also the solvency of exporters themselves. According to Standard & Poor, "Indonesian banks were in such poor shape that they needed $ 15 billion in fresh capital, and their non-performing loans would rise to 20 % with a corresponding erosion of the quality of bank assets." (Mann, 1998, p.133)

In the money market, the continuing high demand for dollars dragged down the rupiah still further, reaching Rp. 10,500 to the US dollar. The government realized that steps had to be taken to halt the rupiah melt down. The most important key to solving the crisis was restoring international confidence by following the IMF recommendations. The following list of recommendations by the IMF caused more severe impacts, as Mann (1998) believed:

> After a signing ceremony with the IMF, the government announced orders to implement an impressive list of reforms which:
>
> - Eliminated exemptions for import duty, VAT and luxury sales tax relating to the Timor car.
> - Abolished the clove monopoly and liberalized the import of ships.
> - Permitted the products of foreign industrial investors to be sold in the retail market and allowed them to operate in the retail sector.
> - Freed plywood producers and wood product manufactures to sell directly to foreign buyers.
> - Restricted the activities of the state Logistics Agency (BULOG)
>
> The majority of these IMF-inspired measures were ideological and aimed at promoting free market practices. (Mann, 1998, p.135)

The IMF mandates that Indonesia curtail the amount of subsidies provided to people with lower incomes and open up the entire retail sector to foreign penetration were outright harmful. The next day the rupiah fell, to close at Rp. 17,000 to the US dollar. The problem was massive dollar buying, and the dollars were now in even shorter supply as offshore banks operating out of the financial centers of Singapore and Hong Kong choked off the supply for fear of a banking collapse in Indonesia. (Mann, 1998, p. 135)

D. SUMMARY

To summarize the major aspects of this chapter, we see clearly that the development of the financial institutions in Indonesia, in line with the trade reform policy, was designed to attract and to facilitate foreign investors. Obviously, investors' confidence is a pre-condition to investors participating in Indonesian businesses, and this confidence is also necessary to boost economic activities. The four significant events in developing financial institutions in Indonesia inevitably reflect the need of foreign investors to support the nation's economic development. Unfortunately, the disadvantage of an open economy forces a country to depend on other countries. As a result, global effects become unavoidable. The Asian financial crisis is a clear example of the dependency resulting from trade among countries. Equally unfortunate, the involvement of foreign investors and the international trade has specific risks, which must be managed seriously. Failure in risks handling erodes the investors' confidence, and the withdrawal of their funds is inevitable. The next chapter will describe the internal factors that contributed to the financial crisis in Indonesia.

THIS PAGE INTENTIONALLY LEFT BLANK

III. CAUSES OF THE FINANCIAL CRISIS IN INDONESIA

In the previous chapter, the external factors, namely the world market factors, were seen as the main culprit of the Asian financial crisis, including Indonesia. This chapter, focuses on the internal Indonesian financial system, which has been accused of being a primary contributor to the financial crisis because its unsound banking systems caused inefficient investment spending and instability.

At least three substantial causes triggered Indonesia's unsound banking system:

- The weaknesses of the Indonesian Central Bank in managing monetary policy
- A package of laws regulating banking reform in 1988
- The exchange rate and foreign capital policy

Each of these contributed significantly to the monetary and currency crisis in Indonesia. Yet, there was another factor contributing to the financial crisis in Indonesia: political instability, which directly impacted financial stability, causing a huge capital outflow in the face of inconsistent government policies. This factor is not discussed in depth as it transcends the scope of the thesis. However, let us examine each of the principal causes of the crisis as listed above.

A. THE WEAKNESSES OF THE CENTRAL BANK IN MANAGING MONETARY POLICY

Banking soundness is an essential condition for effective monetary policy, which is part of macroeconomic policy. "A well-managed macroeconomic policy, including a

good monetary policy to achieve monetary stability, cannot be sustained without a sound banking system."(Djiwandono, 1998, p.5) Despite the continued competition from other financial intermediaries due to the globalization process, the banking sector in a national economy still plays a dominant role, particularly in a developing country like Indonesia. The conditions of the banking system reflect the status of the financial sector as a whole. Particularly the role of the central bank in managing the monetary sector and supervising banks. The central bank's common duties include:

- Conducting the nation's monetary policy by influencing the money and credit conditions in the economy and by pursuing full employment and stable prices.
- Supervising and regulating banking institutions to ensure the safety and soundness of the nation's banking and financial system and to protect the credit rights of consumers.
- Maintaining the stability of the financial system and containing systemic risks that may arise in financial markets.
- Providing certain financial services to the government, to the public, to financial institutions, and to foreign official institutions, including playing a major role in operating the nation's payments system. (Board of Governor of Federal System, 1994, p.1)

A country experiencing banking problems requires a major, expensive overhaul of its banking system in order to have a better banking system. Many domestic factors can be attributable to the primary banking problems. For Indonesia, the first concern was the troublesome role of the Central Bank in managing the nation's monetary policy.

1. The BI's Dubious Role in Managing Monetary Policy

In conducting monetary policy, the central bank basically employs three major tools: 1) conducting open market operations, 2) establishing reserve requirements, and 3) setting the level of interest rates. Let's examine each factor individually:

a. Open Market Operations

The Indonesian Central Bank announced that BI has actively used the open market policy to manage the monetary sector. The BI simply used the Certificate Bank Indonesia (SBIs) as a primary tool to adjust the current money supply. For example, by selling SBIs to banks or non-bank institutions, the BI reduced the money supply. On the other hand, when the BI needed to increase the money supply, the BI bought the SBIs outstanding. This means the BI increased the flow of money into banks and non-bank institutions. Thus, selling and buying SBIs was a primary tool for managing the money supply for a short-term period. (Oppusunggu, 1999,p. 39)

An open market operation is conducted infrequently when the central bank needs some adjustments in supplying money to industry. Thus, the open market operation is stopped when the money supply in industry reaches equilibrium. That means selling or buying SBIs could be stopped at any given time. In contrast, the BI sold SBIs periodically. Apparently the BI has set a target volume in selling the SBIs monthly. In addition, the BI bought the SBIs outstanding when they matured instead of considering the money supply. Target-selling and SBIs redemption when mature are not considered open market operations. The reason for this is that the BI did not have a specific target for how much money is needed or how much money should be absorbed. It seemed that

the BI was trapped by a habitual, routine response. The BI's misperception about the open market operation merely increased the vulnerability of the financial system.

Bank closure was becoming the main disputable issue to the nation's bankers. The BI agreed to close banks under the IMF's prescriptions and thereby eroded the depositors' trust in the banking system. Many of the largest private banks faced liquidity problems as the depositors withdrew their deposits. To reduce the liquidity problem, the BI launched a program named "Bank Indonesia Liquidity Support" (BLBI). BLBI was not a short-term loan but was actually real money used to substitute for deposits. But those banks, which received the BLBI, were not allowed to operate the BLBIs for any business purposes. Demand for the BLBI was growing rapidly from Rp.62.8 trillion in 1997 to Rp. 180 trillion in March 1998. The money in circulation in 1997 was Rp. 356 trillion with the reserve requirement about Rp. 40 trillion, which grew to Rp.566 trillion in Jun 1998. (Oppusunggu, 1999, p.51) It is obvious that BI's Liquidity Support Program ignored the role of an open market operation and contributed to the financial crisis.

b. Reserve Requirements

By definition "reserve requirement" entails the amount of funds that commercial banks and other depository institutions must hold in reserve against deposits. The central bank has the authority to set the level of the reserve requirement. Since banks can expand the supply of money, which is known as the money multiplier, the central bank can limit the money multiplier by increasing the reserve requirement. The reserve

requirement also has another function as stated in "*Purpose & Function*" written by the Board of Governor of Federal System, 1994:

> Reserve requirements continue to be important in the conduct of monetary policy, partly because they provide a stable, predictable demand for aggregate reserves. Without reserve requirements, banks would still hold some balances at the Central bank to meet their clearing needs. Thus, it can more readily achieve a desired degree of pressure on bank reserve positions by manipulating the supply of reserves.(Board of Governor, 1994, p. 56)

The BI controls and sets the reserve requirement. Reserve money, which consists of bank notes, coins circulating outside the BI, treasury notes held by commercial banks, and demand deposits of commercial banks, can be viewed as liabilities on the balance sheet of the Indonesian monetary authority. The assets consist of net foreign assets, net credit to government, net credit to commercial banks, net credit to public sectors, open market operation, and others. (Oppusunggu, 1999, p. 113) The BI policy on the reserve requirement was inconsistent and sometimes confused the banks. For example, banks were required to purchase SBIs from the BI in amounts equal to 80% of the reduction in their required reserves. The banks were permitted to hold up to one-half of their required reserves in vault cash and one-half in noninterest bearing deposits in BI accounts. Most banks had held excess reserves because they did not want to have a reserve deficiency. As a consequence, the liquidity preference of most banks increased, and they tended to hold reserves at a 5-6% level rather than 2% as required. (Ibid.,1999, p. 113)

This policy was confusing and irrational for two reasons. First, by substituting the SBIs for the reserve requirement, the BI bore a higher cost of interest.

Second, banks were reluctant to reduce their reserve requirement, even if they tended to maintain a level 5-6%. To satisfy the requirement of buying SBIs most banks borrowed funds from offshore loans, which offered lower interest rates. As a result, not only monetization took place but also a large amount of money became passive instead of expanding credit nationwide.

The liquidity support program was also confusing. On one hand, the government imposed the tight money policy, but on the other hand, the government injected a huge amount of cash into banks. Hadad (1999) comments: "Reserve money showed a substantial increase from Rp. 36.2 trillion at the end of 1997 to Rp. 70 trillion in June 1998, whereas, demand deposits at BI fell steeply as a result of liquidity scarcity in the banking sector."(Hadad, 1999, p.) The expansion of reserve money resulted mainly from an increase in BI's claims to the banking industry. The increase claims stemmed from the increased liquidity support to banks that faced liquidity problems. Apparently the BI repeated the same mistake by ignoring the impacts of pouring a large amount of money into the banking system.

c. *The Discount Rate or Interest Rate*

The "discount rate" is the interest rate charged to commercial banks and other depository institutions when they borrow reserves from the Central Bank. The Indonesian central bank has been adopting the discount rate policy by requiring the issuance of promissory notes (SBPUs) by the fund borrower or banks. SBPUs carry a specific interest rate, which is approved by BI. When the SBPUs matured, SBPUs was returned to the borrower, and the borrower paid the exact amount of the SBPUs.

To halt the contagion effects on the financial sectors in 1997, the BI was adopting a tight money policy with the intention of lessening the interest of people who speculate in the money market. The BI increased the SBIs' interest rate and terminated the SBPUs. Consequently, banks faced liquidity problems because they had to pay a high interest rates to the BI, but were not making new loans, because potential borrowers were deterred by the high interest rates. For a short-term period the tight money policy was less risky, but it was high risk for longer periods. BI realized that the tight money policy was needed longer than it was predicted. The banks' liquidity and insolvency problems were inevitable since nonperforming loans were also rising.

2. BI Supervision and Law Enforcement

The BI, as the central bank, has been given the right and obligation to supervise the banking system, including private and state banks and non-bank institutions, such as insurance companies and pension funds. Although supported by law, the BI was less than fully effective. "As the central bank, the BI was unable to keep up with the rapid progress and increasing complexity of bank operations, yet on the other hand, banks were lured to overlook prudential principles governing their operations." (Hadad, 1999, p.7)

a. BI Supervision and Its Independence

Bank Indonesia, as the central bank, has been given the authority to supervise and to take any actions in enforcing the regulation of the banking system. Unfortunately, the position of the BI's governor is the same level as a minister. That means the governor of the BI was under the control of president. The role of the central

bank in supervising banks by providing assistance, directions, warnings and sanctions is certainly required. The Bassle Committee (1999) confirmed:

> An important part of the supervisory process is the authority of the central bank to develop and to use prudential regulations and requirements to control these risks, including those covering capital adequacy, loan loss reserves, asset concentrations, liquidity, risk management and internal controls. This purpose is to limit imprudent risk-taking by banks. Minimum capital adequacy ratios are necessary to reduce the risk of loss to depositors, creditors and other stakeholders of the bank and to help the central bank pursue the overall stability of the banking industry. (Basle Committee, 1999, p. 22)

In this case the BI has set the capital ratio requirement at 4% for the core assets and 8% for both core and supplemental assets in relation to risk weighted assets and market risks. When a bank has a ratio that falls below the minimum requirement, the BI should ensure that it has realistic plans to restore the minimum in a timely fashion.

Unfortunately, the BI did not perform this supervision as stated above. The large number of the banks and lack of discipline among bankers to report on a timely basis to the BI were the main reason. As a result, the banking system became worse and worse because so many improper banking practices were allowed to happened. For example, banks were not complying with the required ratio of 8 % of capital risk weighted assets. To illustrate the general condition of the banking sector prior to the financial crisis in Indonesia:

> The position of seventeen banks, among them was the state bank Bapindo, were unclear, as they had not published a financial report in the past two to four years. There have been about 20 banking scandals since 1990 involving outright fraud, with commercial paper, collusion and connected lending. Coupled with the fact that the BI has a hard time controlling the illegal behavior of banks, there have even been reports of BI's officials' involvement in some bank scandals. (Mann, 1998, p.18)

b. Weak Law Enforcement

Although the BI has been given authority to enforce the laws, many bankers gave little attention to the BI warnings. They tended to ignore the existing regulations, such as a limit on lending to connected parties and unsecured loans due to inadequate collateral, etc. Soedrajat Djiwandono, a former governor of BI was quoted as saying,

> ...My major problems were that the BI was not independent of the government and as a member of the cabinet, I was very much a junior minister. My power in supervising banks was largely only on persuasion and in Indonesia any objectives sought through persuasion alone are bound to fail. In other words, my ability to enforce the rules and regulations was strictly limited to the willingness of the bankers to obey. (Mann, 1998, p.18)

For example, Liem Sioe Liong, who received support and protection from the Soeharto administration, owns Bank Central Asia (BCA), the largest private bank in Indonesia. When a run on the BCA occurred in 1997, as much as Rp. 20 trillion by massive depositors' withdrawals, the BCA with 446 branch offices was still able to serve panicked customers due to liquidity support from the BI. This situation was possible because of the BCA shareholder's intervention with the BI. Since, Soeharto's children have substantial shares in this bank, it was understandable that the BI was reluctant to refuse their request. (Mann, 1998, p.16) According to the Info-bank's data report:

> At least four others banks are owned by the Soeharto family. Those banks are Bank Alfa, Bank Utama, Bank Duta, and Bank Yama. Except Bank Duta, their financial condition was in a shaky position. The Soeharto family's abuse of banks, however, is not confined to those they controlled. State banks, even the central bank, were not immune from their intervention. To illustrate, Bank Dagang Negara (BDN) and Bank Bumi Daya (BBD) were forced into releasing loans to projects undertaken by conglomerates of Soeharto's children. (Mann, 1998, p.17)

c. *The Lender of the Last Resort*

The central banks in developing countries usually act as the lender of last resort. There are two reasons for this: the government's inherent interest in the banking system and the causal relationship between the central bank and all other banks. The government in a developing country like Indonesia must oversee banks as part of the nation's payment system and regulate the banks' ability to mobilize funds from various sources and to distribute those funds to private or government's projects. Clearly, due to the national significance and uniqueness of the banks' functions, the government definitely does not want banks to fail or undergo bankruptcy.

The central bank and banks institutions are team members in the nation's payment system. There is no question that if one of them malfunctioned, either the central bank or the banks, it would create financial instability. As a team, they have to work together; a failure on one side affects the other side and leads to financial instability. Considering this relationship, the central bank was forced to help the troubled banks.

B. FINANCIAL REFORM DEREGULATION PACKAGE OF 1988

In order to promote the development of the industry, mobilize domestic saving, and encourage competition among banks, the Ministry of Finance introduced a package of deregulation in October 1988, known as PAKTO 88. Before 1988, the industry was dominated by the seven state commercial banks, which provided over 60% of all credits outstanding. Four disputable issues were identified by the government and were taken into consideration:

- Whether to open up the licensing of new commercial banks and branching of the existing banks.
- How to reduce the differential taxation of interest income on time and saving deposits from that on interest and dividend income on securities.
- Whether to eliminate the requirement that state owned enterprises must only have banking relationship with the state banks.
- Whether to permit participation of new foreign banks.

1. Significant Key Provisions

The package of deregulation contained three significant key provisions, which altered the banks' community and required them to comply with these regulations promptly.

a. Bank Entry Policy

When the Indonesian government set the initial capital requirement for new domestic banks both negative and positive repercussion arose. Many groups wanted a higher capital requirement to limit applications for new licenses, while others wanted to encourage many new applications and therefore keep the capital requirement low. The final agreement was settled and affected three categories of banks. People's credit banks were required an initial capital of Rp. 50 million. Private banks were required an initial capital of Rp. 10 billion, and joint venture banks were required an initial capital of Rp. 50 billion. (Cole & Slade, 1996, p. 114) The foreign banks were permitted to establish joint venture banks, with 85% of their ownership. They were permitted to open their branch

offices in seven large cities outside Jakarta. The bankers responded happily because they believed that the easy approval and the low capital requirement for new banks would not last indefinitely.

b. Reduction in Tax Differentials on Interest Income and Dividend

In order to obtain greater revenues, the government was targeting taxation as the second largest source of the government's income. This effort led the government to review the existing regulation on the taxation system. Prior to the establishment of the PAKTO 88, interest and dividends were not subject to tax. Imposing taxes on these personal incomes would increase the tax collections. But this issue invited pros and cons. Finally, reduction of the differential in the tax treatment of bank deposits and other securities resulted in an agreement that a tax should be imposed on time deposit interest. Cole & Slade (1996, p. 11) illustrated the situation above:

> The concern about higher loan rates was that they could discourage investment and increase producers' cost. On the other side, lowering deposit rates could lead to capital outflow. One way to offset a tax on deposit interest income would be to lower the reserve requirement, which earned no interest and was criticized as a kind of implicit tax on banks that was passed on in the forms of both higher interest rates and lower rates on deposits. The existing reserve requirement was 15%.

Offsetting the implicit tax led to the decision to reduce the reserve requirement to a uniform level of 2% of all third-party liabilities.

c. Eliminating the "Bound" Relationship between State Banks and Enterprises

Permitting state enterprises to move some of their banking business out of the state banks was seen as a means of promoting competition and weakening outside

interference in bank decisions. Eliminating the required relationship between state enterprises and state banks encouraged the state enterprises to shift their deposits to and to apply for loans from private commercial banks for their projects. This shift from state banks to private banks occurred because private banks offered easier procedures and were more efficient in doing business. Soon, the state banks realized that smaller profits could be earned due to a large amount of capital outflow and significant contraction in their credit loans and liquidity problems resulted. This in turn forced these banks to begin improper lending practices.

In conjunction with the promotion of bank competitiveness, the Ministry of Finance imposed a limitation on loans to individuals or to affiliated groups to reduce risks and to prevent big depositors from influencing bank decisions. "The lending limit was set at 20% of capital to a single borrower and 50% of capital to a group of borrowers, and for the state's enterprises were permitted to hold up to 50% of their deposits in state's banks, but no more than 20% in private banks." (Cole & Slade, 1996, p.112)

2. The Impact of PAKTO 88

The package of deregulation of October 1988 was known as the Financial Liberalization Reforms. These reforms made it easier to establish both domestic and foreign banks. It also made it easier for existing domestic and foreign banks to add branches, and it also allowed private banks to compete fairly for the deposits and loans of the state owned enterprises.

a. Introducing Secondary Money Market Vs Monetization

By publishing PAKTO '88, banks were forced to buy SBIs. Seemingly BI was trying to use this policy to develop a secondary money market for debt instruments. To promote SBIs, the BI conducted several meetings with the nation's bankers to emphasize that SBIs were tradable among banks. Moreover, BI allowed all SBIs outstanding to mature without requiring them to be rolled over.

Substituting the amounts of the reduction in reserve requirement into the form of SBIs created a liquidity squeeze. Thereby, the BI reduced the money supply significantly and immediately. In addition, most banks were uninformed prior to the publication of PAKTO 88, so they were surprised and were limited by time to provide funds to buy SBIs. Many banks repatriated their funds, especially from Singaporean banks, and others sought offshore borrowings, which lower interest costs. Banks viewed the latter favorably. Thereafter, offshore loans became a major method of funding, not only to buy SBIs, but also as fund resources when they were converted into domestic currency. Unfortunately, the BI allowed this activity by facilitating the swap exchange, which allowed banks to exchange foreign currency into domestic currency, mostly for U.S. dollars. This process is called "monetization," which added to the fragility of financial stability.

b. Expansion of Credits and Loans

Since PAKTO '88 eased the standard for the licensing of new banks, it resulted in a large number of new banks being licensed in the following years. The number of commercial banks doubled, rising from 124 banks in October 1988 to 240

banks in 1994, and the banking network also increased from 1,800 offices to more than 7,000 offices nationwide. Obviously, the growing number of new banks contributed to high competition among banks. "The growth rate of both deposits and loans increased dramatically at a rate of approximately 80% a year for the period December 1988 to December 1990, compared to the previous years." (Cole & Slade, 1996, p.115)

The large amounts of offshore borrowings that were converted into domestic currency merely halted the reduction in money supply. Foreign investors thought that making investments in Indonesia was favorable since Indonesia offered higher interest rates. In addition, all SBIs outstanding, which were sold forcedly in 1988, matured and did not require a rollover. These factors contributed to an unanticipated increase in the money supply. This increase quickly encouraged higher consumption and maximized the banks' credits and loan.

c. *Unsustainable High Economic Growth*

This aggressive competition among banks caused high expansions both in credits and loans, which probably contributed to accelerating the overall economic growth without adversely affecting the relative price stability and the balance of payments equilibrium. After PAKTO 88, the Indonesian economic performances improved rapidly. For example, "the real rate of economic growth rose from 6% in 1988 to 7.5% in 1989, and the inflation rate declined from 8.1% in 1988 to 6.0% in 1989, while the net foreign exchange reserve increased modestly." (Cole & Slade, 1996, p.115)

But these improved performances were unsustained. In early 1990, economic growth overheated as a result of an unanticipated high increase in the money

supply. Offshore borrowing that was then converted to BI increased the foreign exchange liabilities as much as $ 8.7 billion in 1990. In addition, SBIs redemption added to the money supply as much as $ 1.3 billion. Moreover, the reduction of the reserve requirement to 2 % also increased the money supply. In turn, rising high inflation and deficits in the balance of payments threatening financial stability.

C. THE EXCHANGE RATE & FOREIGN CAPITAL POLICY

The Indonesian economic experts, who were mostly educated in western countries such as in the U.S. and in the European countries, proposed an open economy policy to the government. They believed that by opening trade with the world, they would enjoy cheaper prices and a larger volume of goods than a country which adopted a closed economy policy. To export and to import goods and merchandise, a currency exchange agreement is needed because the currency is different.

"In April 1970, the Indonesian government decided to implement a fully convertible foreign exchange system, with a unified fixed exchange rate, no significant restrictions on capital outflows and only minor limitations on capital inflows." (Cole & Slade, 1996, p.43) This decision was urged by IMF to terminate the multiple exchange systems, which had been used since 1966. In addition, the Minister of Trade, Professor Soemitro, and the Minister of Finance, Professor Wardhana, preferred a fixed rate system that would help control inflationary pressure and instability, and also eliminate foreign exchange controls and allocation systems to minimize corruption. The new exchange rate policies adopted in April 1970 consisted of:

- Unifying the exchange rate at the prevailing free market of Rp. 378 per US dollar.
- Fixing the rate for an indefinite period and absorbing any foreign exchange surpluses or meet any deficits by purchases and sales of foreign exchange by the BI.
- Closing the Foreign Exchange Transaction Board and abolishing the old regulations for allocation of foreign exchange. (Cole & Slade, 1996, p. 43)

The Indonesian government chose a fixed exchange rate regime, for two reasons: To reduce transaction costs and exchange rate risks, which discourage trade and investment; and to provide a credible nominal anchor for monetary policy. For example, by fixing the exchange rate the central bank could commit more credibly to fighting inflation, because the currency peg would prevent the central bank from expanding even if it wanted to.

1. Balance of Payments and Foreign Exchange Reserve

a. Current Account Deficits

The current account is a common measure of international payments, which is more comprehensive than net exports, and includes net interest payments on foreign borrowings and lending and miscellaneous transfers between countries. It not only measures the flow of cash arising from trade and transfers, but also measures indirectly the economy's international financing requirements. Data on the current account positions provide some preliminary evidence that the currency crisis may have been associated with an external competitiveness problem. Mishra (1980) appraised the Indonesian government effort:

> In the 1980s, the balance of payments situation was managed by restraining import, which was achieved primarily through the introduction

of non-tariff barriers such as the devaluation of the Rupiah that induced a switch in demand from imports to domestic substitutes. The current account deficits fell from 7.9% of GNP in 1982 to 4.0% of GNP in 1990. The specific measures that helped restore balance of payment stability included: depreciation of the real exchange rate; re-phasing of large capital and import intensive projects and cutback in real public expenditures; tight monetary policy; trade and regulatory reforms which stimulated non-oil exports. (Mishra, 1980, p. 121)

Indonesia started the 1990s with large current account deficits, as much as 4.0% of GNP, but the deficit shrank in 1993, then widened again, reaching 3.0% of GNP in 1996. Financial variables that affect in an important way the sustainability of the large current account deficits consist of the composition and size of capital inflows, foreign exchange reserve and debt burden, fragility of financial system, and political instability.

In the 1990s, the composition of capital inflow to Indonesia consisted mostly of short-term loans. Unfortunately, the private sector used short-term loans in a bigger proportion than the government. Unlike the government, the private sector invested most of the loans in long-term projects. When a large depreciation of the domestic currency occurred, the private sector experienced a huge loss. Radelet & Sach (1998) pointed out the problems of short-term loans:

The composition of the capital inflows necessary to finance a given current account deficit is an important determinant of sustainability. Short-term capital inflows are more dangerous than long-term flows and equity inflows are more stable than debt-creating inflows. A current account deficit that is financed by large foreign direct investment is more sustainable than a deficit financed by short-term "hot money" flows that may reversed if market conditions and sentiments change. However, Indonesia has experienced a large stock of short-term loans from foreign banks, which may lead to a debt crisis if a panic ensuing a currency crisis leads foreign bank to refuse to rollover the loans that come to maturity. The currency composition of the foreign liabilities of the country matters as well. While foreign currency debt may lead to greater capital inflows at a lower interest rate than borrowing in domestic currency, foreign currency

> debt may end up exacerbating an exchange rate crisis as a real depreciation leads to an increase in the real burden of foreign debt. (Radelet & Sach, 1998, p.7)

This is exactly what happened in Indonesia in late 1997, when the currency crisis turned into a debt crisis as the depreciation of the currencies led to a rapid and dramatic increase in the domestic currency burden of foreign-currency denominated debt.

b. Foreign Exchange Reserves

The existence of large foreign exchange reserves facilitates the financing of a current account deficit and enhances the credibility of a fixed exchange rate policy. Foreign exchange reserves and a small external debt burden reduce the risk of external crisis and enable financing a current account deficit at lower costs. The real rate paid on the country's debt is an indication of the market's evaluation of the country's ability to sustain a current account deficit.

When a country exports goods and services, it increases the amount of the foreign reserves, whereas, imported goods and services reduced the foreign reserves. Since imports reduce the foreign reserves, that implies that foreign reserves are vital to the country to pay for its consumption from abroad. Foreign reserves serve as a measure of ability to import goods and services. Roubini (1998) explained further about the measurement of foreign reserve:

> A traditional measure of the adequacy of foreign exchange reserves is the stock of reserves in months of imports of goods and services. As rapid outflows of speculative money have become a more important source of foreign exchange pressure than trade imbalances, the traditional measure is no longer used. A better measure of the adequacy is the ratio of money assets to foreign reserves, since in the event of an exchange crisis, all liquid money assets can potentially be converted into foreign exchange.

> The ratio of M2 to foreign reserves constantly rose throughout the 1990 and reached a peak as high as 7.09% in 1995, and the ratio of M1 to foreign reserves was about 1.21%. (Roubini, 1998, p. 35)

The ratio of total short-term external liabilities to foreign reserves at the end of 1996 was 181%. This means, in the event of a liquidity crisis, foreign banks were no longer willing to roll over short-term loans in Indonesia.

The fixed exchange rate leads over time to real appreciation and a worsening current account deficit. As the real appreciation becomes worse and the current account keeps on worsening, more and more foreign capital inflows are needed to finance the current account deficit. When investors start to realize that the fixed rate is not sustainable they start to believe that devaluation might occur. This expected depreciation leads to an increase in the expected return on foreign assets and, for given domestic interest rates, leads to capital outflows. Then the domestic foreign reserves of the central bank start to fall as it intervenes in the exchange rate market to defend its currency from depreciating. As the expected depreciation materializes, the loss of foreign reserves occurs at an even faster rate as capital outflows. It happened during the third quarter of 1997, and the BI had widened the band from 8% to 12%, but it did not work. The BI recognized the loss of some of its foreign reserves, and decided to move to a flexible exchange rate. The speculative attack on domestic currency lead to a sharp and large devaluation of the exchange rate. By early 1998 the value of the Rupiah fell to the lowest in history, reaching 17,000 per US dollar.

2. Foreign Capital Policy

A country which applied the open economy policy would likely be better off, but greater openness also makes it more vulnerable in terms of trade shocks and uncontrolled capital outflows. Indonesia in the 1980s initiated a series of reforms streamlining investment approval procedures and reduced licensing and other controls on domestic and foreign investment. "One of the major aims of the structural adjustment programs was to move the economy from an inward oriented and oil dependent growth path to a country which was more outward oriented and based on more diversified productions." (Mishra, 1980, p.122)

Those policies created an environment conducive to business transactions, inducing a sharp increase in both domestic and foreign investment. "Domestic investment rose by 134% in 1987, a further 45% in 1988, and doubled in value in 1991, similarly the foreign investment rose by 76% in 1987, a remarkable 300% in 1988 with value of $ 4.4 billion, and increased to $ 8.75 billion in 1990." (Mishra, 1980, p.112) As a consequence, the external debt was also rising because of falling oil prices in the 1980s and increased reliance on external assistance, which a total from $ 13.4 billion in 1980 to $ 44.3 billion in 1990.

Increasing gross external liabilities became a serious issue in 1997, because once the currency crisis started, large gross capital outflows exacerbated the crisis in two ways. First, as the currency fell, non-residents were repatriating the capital inflows by dumping domestic bonds, equities and other financial assets; and residents, who had accumulated large stocks of financial capital, were unwilling to repatriate such foreign currency

outflows as their domestic currency was falling. Second a large fraction of the gross capital outflows were in the banking sector. This process of large gross intermediation of capital inflows and outflows through the banking system implied that the domestic banks were increasing their foreign short-term liabilities much faster than their foreign assets. (Roubini, 1998, p. 29)

"Under the fixed exchange rates and perfect capital mobility, the central bank has no control over the money supply, therefore, it has no monetary autonomy since the central bank has less power to set the money supply and the domestic interest rate." (Roubini, 1998, p.19) To defend stability of the currency, the central bank intervenes in the market by selling foreign reserves. In turn, this intervention reduces the money supply and increases the domestic interest rate up to the new higher world interest rate. At this point, the loss of foreign reserves stops. Any attempts to intervene in the market through an open market operation will lead to an equal and offsetting loss of foreign exchange reserves with no overall effects.

D. SUMMARY

The root of the internal causes of the financial crisis in Indonesia involved three broad areas: the weaknesses of the Bank Indonesia as the central bank, the negative effects of the banking reforms in 1988, known as PAKTO 88, and the dubious exchange rate and capital policy.

The BI, as the central bank, was supposed to supervise banks, to enforce the laws, and to punish banks that violated any rules. But the BI did not carry out those duties

properly. In addition, the BI was seen as incapable of conducting its duties, especially regarding monetary policy. Misperception in performing its tasks in regulating the monetary sector weakened the financial stability. Either external intervention or inadequate internal control made the BI's performance poor.

In many developing countries, government involvement to promote and to boost economic growth were properly needed. By issuing regulatory policies, the government provided certain guidelines to the public on how to engage and participate in business. When the government issued a policy with inadequate considerations, it might lead to negative outcomes. For example, a package of laws regulating banking reform in 1988 was beneficial in the short-term, but harmful in the long-term.

The exchange rate and capital policy also contributed to the financial crisis in Indonesia. Free exchange flows inspired banks and the private sector to borrow offshore loans with no obligation to report to the BI. Unfortunately, both bankers and the private sectors perceived that offshore loans were more favorable than domestic loans. Eventually, offshore loans grew dramatically and were not under the BI's control. When the financial crisis happened both bankers and the private sector panicked easily. The next chapter will explain the government's efforts to overcome and to resolve the financial crisis in the banking sector.

THIS PAGE INTENTIONALLY LEFT BLANK

IV. THE GOVERNMENT EFFORTS TO OVERCOME THE FINANCIAL CRISIS IN INDONESIA

This chapter will explain the government efforts to overcome and to recover from the Asian financial crisis, which nearly collapsed the banking system. Many policies have been applied and implemented simultaneously by the government in order to solve and to recover from the crisis. Basically, the Indonesian government has attempted to implement two major strategic programs for the banking sector:

- Recapitalizing and restructuring the banking system.
- Reviewing the government's regulation of the banking system.

A. RECAPITALIZING AND RESTRUCTURING THE BANKING PROGRAMS

The Government issued Presidential Decree of the Republic of Indonesia No. 27 of 1998 and Regulations of the Government of the Republic of Indonesian No. 17 of 1999 to establish the Indonesian Bank Restructuring Agency (IBRA). To accomplish the mission, the IBRA has developed a systematic, consistent and comprehensive restructuring strategy, which consists of three programs:

1. Commercial Banks Liabilities Guarantee Program
2. Bank Restructuring and Recapitalizing
3. Sale of Assets and Recovery of State Funds

1. Commercial Banks Liabilities Guarantee Program

In order to restore public confidence and to restore the banking sector, the government has issued a policy of guaranteeing the liabilities of commercial banks. "This program was designed to have a minimal impact on the government budget and the balance of payments." (BPPN, 1999, p.12) In addition, the IBRA has strived to extend the maturity dates of commercial bank liabilities of both foreign creditors and domestic creditors through participation in the exchange offer.

a. Cooperation with Bank Indonesia

Through joint cooperation with the BI, the IBRA would implement the programs. Due to difficulties in obtaining data for verification purposes, BI's cooperation and outsourcing of collection assets held abroad to third party consultants were needed. Outsourcing would accelerate the process and reduce costs because they work professionally and efficiently.

b. Limitation on the Types of Liabilities Guaranteed

In order to prevent massive withdrawal and to restore public confidence, the government launched a bank's liabilities program. Under this program, depositors were guaranteed that their money was safe, although the banks that held their money were closed. To implement the guarantee program, the government appointed the seven state banks to provide cash in the case of withdrawal. To prevent cash flowing out of the government's pocket without sufficient documents and approval, the government issued a list, which contained excluded items from the guaranteed program. The IBRA acknowledged this program as written in the "*Rencana Strategis1999-2004*":

- All commercial bank liabilities are guaranteed under this program, except the following:
- Equity loan and subordinated loans
- Liabilities which cannot be verified and liabilities arising from irregular banking practices
- Liabilities to the board of directors/board of commissioners and related parties
- Liabilities in respect of checking accounts, savings accounts, term deposits, on call deposits, and other securities which carry above-market interest rates
- Claims, which are not accompanied by valid documents within 60 days of the maturity date. The government charges a premium to program participants to offset the impact of the program's cost to the government budget. (BPPN, 1999, p.12)

c. Exchange Offer

Providing funds to support this program without altering the budget was the primary concern. Finally, to minimize pressure on the state budget and the balance of payments, the government established an exchange offer, designed to extend the maturity dates of the claims of foreign creditors on Indonesian banks.

2. Bank Restructuring and Recapitalizing

The Indonesian government would not receive the IMF's loans to support recovery programs unless the government made serious efforts to revive the banking system. As a response to the IMF prerequisite, the government established the bank restructurization and recapitalization program.

The purpose of the program was to create a healthy banking system, characterized by globally competitive banks that meet international standards and have good management and adequate risk management. Banks with good performing assets would

be capable of meeting their own liabilities without involving the government. Nevertheless, many banks would still be unable to meet all of their liabilities and therefore, the government would be responsible for those liabilities. The process of the recapitalization program was illustrated in the *"Rencana Strategis1999-2004":*

> The recapitalization program began with an appraisal of the financial position of each bank in accordance with the international standards. Independent accountants of international standard conducted this appraisal.
>
> - Banks with Capital Adequacy Ratio (CAR) of above 4% are classified as Category A banks and are permitted to continue operating without government interference.
> - Banks with a CAR of between 4% and negative 25% are classified as Category B Banks, and subsequently either taken over or placed in the bank recapitalization program.
> - Banks with a CAR of under negative 25% are classified as Category C Banks and are frozen, except if their owners fund a recapitalization to a minimum of a 4% CAR.
> - After the financial audit, the selection process continues with an appraisal of commercial prospects, paying special attention to franchise value. (BPPN, 1999, p.19)

In addition to commercial prospects, an evaluation was conducted of the competence and integrity of management and controlling shareholders. All of the above appraisals are conducted jointly by Bank Indonesia, the IBRA and the Department of Finance, under the supervision of the IMF, World Bank and Asian Development Bank. After intensive evaluation, the government created the following four categories to deal with the 128 private domestic banks:

a. Bank Which Could Continue Operation Without Recapitalization

There were 74 banks in Category A, with a CAR 4% or more. It was determined that these banks met Bank Indonesia's minimum capital adequacy requirement and could operate without financial assistance from the government. Capital injections by the bank owners have been verified and approved by the Evaluation Committee (Bank Indonesia, Ministry of Finance, and Indonesian Bank Restructuring Agency). These banks would continue to be monitored closely to ensure they remained in good financial health and continued to observe the regulations. (BPPN, 1999, p. A-15)

b. Nine Banks Were Eligible for the Recapitalization Program

It was determined that nine banks were eligible for the bank recapitalization program: Bank International Indonesia, Bank Lippo, Bank Bali, Bank Niaga, Bank Universal, Bank Bukopin, Bank Patriot, Bank Artha Media, and Bank Prima Express. On April 15th, 1999, recapitalization agreements were signed between those banks and the government represented by IBRA. The controlling shareholders of the nine recapitalization participant banks agreed to fund their 20% of the recapitalization requirements by placing cash into escrow accounts not later than by April 22nd, 1999. (BPPN, 1999, p. A-15)

c. Thirteen Banks Were Taken Over by the Government

The Government took over thirteen banks in Category B which had a large number of customers and a widespread branch network. The decision to take over these banks was based on consideration of public interest to prevent disrupting the payment

system. Banks, which were taken over are still open to serve clients. With the take over, the banks were 100% owned by the government and the bank owners no longer had any authority over the banks. The Government assessed the management of the banks and made changes if necessary. (BPPN, 1999, p. A-15) The old owners were required to repay their debts to the banks, in accordance with the set precedents. How to treat the taken over banks was explained in the "*Rencana Strategis1999-2004*":

- The resolution and recapitalization of BTOs (bank taken over) are carried out based upon the joint decision of the Minister of Finance and the Governor of the BI.
- **Taking Over Management**. The IBRA plays an active role in the management of BTOs through placing IBRA managers in each BTO.
- **Shareholder Settlements**. The IBRA coordinates shareholder settlements whereby former shareholders are requested to pay all of their groups' liabilities.
- **Resolution**. The IBRA recapitalizes designated BTOs by means of temporary capital participation. (BPPN, 1999, p.23)

Thirteen banks have been taken over and classified into three groups by the IBRA. The first group consists of four banks that were taken over by the IBRA in 1998. These banks include BCA, Bank Tiara Asia, Bank Danamon and Bank PDFCI. The second group consists of seven banks, Bank Duta, Bank Nusa Nasional, Bank Pos, Bank Jaya, Bank Tamara, Bank Rama and Bank Risjad Salim Internasional. This group would not be recapitalized as autonomous banks and would be merged with other BTOs. The third group consists of Bank Niaga and Bank Bali. These banks were previously included in the recapitalization program, but their status was changed, as their shareholders did not participate in the recapitalization process. (BPPN, 1999, p. A-15)

d. Forty-eight Banks Were Closed

The government has closed 48 private domestic banks, consisting of 10 banks in Category B and 38 banks in Category C. Bank closure was considered only when the banks were deeply insolvent and had no prospect of regaining financial viability. The old owners were required to repay their debts. The owners of deposits, savings and other accounts at the closed banks were fully guaranteed by the government. These banks were treated similarly by the IBRA:

> In the case of banks whose operations have been frozen, the IBRA has carried out the following actions:
>
> - **Payment of Bank Liabilities**. In accordance with the government's guarantee program, the IBRA would pay all the eligible liabilities of the frozen banks.
> - **Transfer of Bank Assets**. All the assets of frozen banks were transferred to the IBRA.
> - **Liquidation**. In the final stages, the IBRA would assist Bank Indonesia in liquidating the frozen banks to avoid any subsequent claims against the IBRA. (BPPN, 1999, p.25)

e. Improving Bank Management

Inadequate knowledge on the parts of the banks' managers was one of the internal factors that caused the Indonesia financial crisis. To promote banking soundness, the government focused serious attention on how to improve the managers skills. Since then, a series of programs has been designed to improve the quality of bank management. These programs encompass contract management, technical assistance, and the establishment of adequate incentive programs for both management and staff. The program is designed to correct the deficiencies in the existing reporting system and to improve the level of compliance with the BI regulations. Through this program the

number of banks in Indonesia would be dramatically reduced and the remaining banks would be healthier. A number of regional banks and some smaller banks would continue to serve their respective regions. (BPPN, 1999, p. 14)

3. Sale of Assets and Recovery of State Funds

The sale of assets and the recovery of the state funds are the most critical event. To complete the IBRA's mission the government has funded as much as Rp. 634 trillion. This cost was about 71% relative to the GDP, and it was more than twice the cost of the recapitalization-banking sector in other Southeast Asian countries. (BPPN,1999, p.49) In undertaking asset divestment, the IBRA used some methods to maximize their sales value:

- Sale of company shares to strategic investors
- Initial Public Offerings
- Loan and financial asset sales
- Monetizing assets through securitizations

a. Sale of Shares to Strategic Investors

The IBRA would employ the selling methods that fit the market conditions, the prospective investors, and the size of the company. If there is only one party who shows keen and certain interest (particularly shareholders or joint venture partners of the company), that party has preemptive rights. The public offering process will be preceded by an "exclusive offer period for the preferred bidder." By employing this hybrid bidding process the preferred bidder has an opportunity to make an exclusive

bid, while at the same time allowing the IBRA to invite other competitive bidders. (BPPN, 1999, p.33)

b. Initial Public Offering

There were various methods of selling assets, but the IBRA was aware that selling assets without careful considerations would lead to a lower price. The market demand for those assets was stable either from domestic investors or foreign investors. The IBRA did not sell the assets partially or as a whole immediately because they wished to avoid a cheaper price below the IBRA's standard.

To prevent selling assets below standard prices, the IBRA collected data about the potential buyers, including nonbank financial institutions and especially the parties who previously owned the assets. They were contacted and given a priority to purchase the assets. The main reasons for using the initial public offering were described in the following sentences:

> One of the benefits of this method includes the facilitation of capital inflows through widespread ownership while maintaining existing management. The prospective equity investors, such as fund managers, pension funds, retail and small-scale investors, become potential buyers. The sale of shares to retail and small-scale investors will assist the government in its efforts to expand the public ownership of domestic companies. (BPPN, 1999, p. 35)

c. Sale of Loan Assets

The IBRA's divestment strategy was as follows:

- The sale of loan portfolios would be carried out after the IBRA had successfully concluded the restructuring process.

- The sale of portfolios of small and medium-scale corporate loans and retail loans would be conducted as soon as possible.

- The sale of other bank assets, such as property and other financial investments, would be carried out by category and depend on the market demand. (BPPN, 1999, p.35)

The IBRA would approach interested investors or hold a public tender. The choice depended upon the type of asset and investor interest. The IBRA would use various structures in forming financial asset portfolios to maximize the value of the assets. The structures that may be employed include receivables-backed securities, collateral financing, or other structure which the IBRA has carefully considered.

d. Monetizing Assets through Securitization

The securitization of corporate earnings is another method. That is, the issuing company guarantees the issuance of various types of debt instruments. The IBRA could propose to selected corporations to issue corporate bonds or promissory notes with specific assets provided by the IBRA as collateral. The IBRA securitization approach:

> In addition, the possibility of issuing convertible bonds, whereby upon maturity the investor is given the option of choosing between receiving cash or a number of shares in a selected company, needs to be explored. The choice of the best companies to issue such instruments will be based upon the quality of their revenue and cash flow. The best candidates are export-orientated companies, which have long-term contracts with reputable multi-national companies, with good growth potential. (BPPN, 1999, p.36)

B. REVIEW THE GOVERNMENT'S REGULATIONS ON THE BANKING SYSTEM

In order to speed up the recovery of the banking system, the government has reviewed the existing regulations of the banking system and has taken steps to improve them. To illustrate, the government enacted the Act number 10 of 1998 dealing with the banking system, as a substitute for the Act number 7 of 1992. In addition, the Act number 23 of 1999 on the central bank or Bank Indonesia was established to replace the Act number 13 of 1968. The government also issued the Act number 24 of 1999, dealing with the foreign exchange flow and exchange rate system as a response to the financial crisis.

1. Establishing the Act No. 10 of 1998 on the Banking System

This act was established merely as a result of modifying the Act number 7 of 1992. The content was based on the Act number 7 of 1992 and some additional materials. Significant new materials in this Act includes:

- Opening branches permission
- Banks' obligations to maintain wealth
- Public accountant examination

a. Branching Permission

According to the Act no. 7 of 1992, banks must get the Minister of Finance's approval to open branch offices. As a result, most bankers were reluctant to report to the

BI about their branch offices. Eventually, the BI was no longer informed of the actual status of banks and this created obstacles in supervising and controlling them.

The Act no. 10 of 1998 was made as a response to this uncomfortable situation. The BI was given the authority to approve branch offices of the banks. In this way the BI was able to maintain and to supervise the banks.

b. Banks' Obligations to Maintain Wealth

Under the Act no. 7 of 1992, banks were required to maintain their wealth with respect to quality of assets, quality of management, liquidity, and solvency. Banks were also required to report their activities to the BI. As discussed earlier, most bankers tended to ignore or were simply incapable of following the regulation stated above. In addition, bankers or bank owners criticized the BI since the BI's instructions for reporting this information were unclear. Moreover, the BI's former governor stated that those bank managers were part of the problem because they lacked knowledge. As a result, the bankers were reluctant to submit their activities report to the BI. This reduced the BI's ability to supervise banks and, thus, made the banks' condition even worse.

To respond to the above situation, the government, through the Act no.10 of 1998, improved the existing regulation by adding some mandates. Banks are still required to maintain their wealth, but if banks failed to maintain their wealth and threatened the nation's economy, the government can establish a special entity temporarily to revive those banks. The objectives are to accommodate the government effort in reviving the banks and to prevent lawsuits by bankers or bank owners. In fact, these objectives inspired the government to establish the IBRA.

c. Examination by Public Accountant

The Act no. 10 of 1998 allows a public accountant to perform due diligence over the banks. Indeed, before submitting their activity report, banks are required to obtain a public accountant's certificate of examination. This issue was not addressed in the Act no.7 of 1992.

Apparently the government realized that the BI's duties were overloaded. Reducing the BI's burden by involving a public accountant guarantees that banks are complying with the regulations. Under this act, the BI is still the main supervisor over the banks. But, the BI is allowed to appoint a public accountant in the name of the BI to perform due diligence over the banks.

2. Establishing the Act No 23. of 1999; Bank Indonesia

The Indonesian government is also improving the regulations of the central bank. In this case, the BI, as the central bank, was seen as being incapable of performing its duties because of external intervention, including that by the government. The Act no. 23 of 1998 was intended to protect the BI from external pressures. This act has three significant features that came about as a result of modifying the previous act no. 13 of 1968.

- Authority to open and to close bank.
- The BI's governor and his rights.
- Transparency to the public.

a. Opening and Closing Authority

Prior to the financial crisis, the BI was powerless in conducting law enforcement. Two reasons explain this condition. First, the Act no. 13 of 1968 provided the BI inadequate power to control banks. Bankers and bank owners felt secure even when they broke the BI's regulations. They believed that BI's sanctions were negotiable because they enjoyed a close relationship with the top level of the government. Second, the BI was overloaded with duties; and the number of the banks was so large, that the BI was unable to supervise each bank closely. As a result, the BI supervised poorly.

By establishing the Act no. 23 of 1998, the BI is given authority to close a bank that seriously violates any regulation. When a bank's operation is closed, all the employees are laid off and the banker and the bank owner is responsible for them. The banker and the bank owner can either pay three months salary or transfer them to other banks with equivalent jobs. It is obvious that such a closure is the bank's biggest risk. So banks no longer perceive that the BI is powerless and its regulations negotiable.

b. The BI's Governor and His Rights

During President Abdurahman Wahid's administration, the government has tried to promote a government free of corruption and nepotism. To assure the central bank's independence, the government is rewriting the existing laws controlling the central bank. As a result, the governor of the BI has been given more authority to resist external intervention.

Under the Act no. 23 of 1998, the president appoints the governor and a senior deputy to the BI with the House of Representatives approval. Under the old act, the

president can appoint or replace the governor of the BI without the House of Representative's approval. In addition, the appointed governor holds the job for four years. During this term, the president cannot replace the governor of the BI. In contrast, according to the Act no.13 of 1968, the president was able to fire the governor of the BI at any time. Moreover, now the governor of the BI is immune from a court trial as long as he performs his duties appropriately. There is no question that the government has been promoting the independence of the BI.

c. *Transparency to the public*

Unlike the Act no. 13 of 1968, the new act, number 23, requires the BI to announce its monetary evaluation, its financial condition and other activities to the public periodically. The BI is also required to submit a formal report both to the president and to the House of Representatives. In addition, the Indonesian Supreme Audit Board and public accountants can examine the BI. Basically, these policies are intended to restore the public's confidence in the banking sector.

3. Establishing the Act no. 24 of 1999

The Act no. 24 of 1999 concerning the flow of foreign exchange and the exchange rate system basically is a result of rewriting the Act no. 32 of 1964. The government considered that the old act no longer accommodated the rapid changes in financial transactions internationally. In particular, the BI had no authority to force banks to report their international transactions, which caused the foreign exchange flows. As a result, the BI could not control foreign exchange flows adequately.

The Act no. 24 of 1999 provides the BI with sufficient authority to control the flow of foreign exchange. There are two significant objects in controlling the flow of foreign exchange:

- Residents
- Banks and NBFIs

a. Activities of the Foreign Exchange Conducted by Residents

The Act no. 24 of 1999 allows the BI to request information concerning the movement of assets and financial liabilities conducted by residents. According to this act, the definition of 'resident' is, " people, legal entity, and other entities that are domiciled or plan to domicile in Indonesia at least one year, including the representative and diplomatic staff of the Republic of Indonesia." (Act no.24 of 1999, Art. 1) In addition, the act also requires the residents to report each time they have a transaction using foreign exchange.

Considering the importance of foreign exchange in maintaining the stability of the Rupiah, uncontrolled foreign exchange flows increase the vulnerability of the Rupiah. Controlling residents who make foreign exchange in their business transactions is equally important in maintaining the stability of the Rupiah.

b. Foreign Exchange Activities Conducted by Banks and NBFIs

The core objective of this act is to control the movement of foreign exchange conducted by banks and non-bank financial institutions. Since 1970, the Indonesian government has had a free-foreign exchange flow. Consequently, most banks and NBFIs sought offshore borrowings, and unfortunately they were not required to

report these activities. As a result, when the crisis occurred, the BI was unable to estimate total foreign debt accurately, which led to a crisis of confidence among creditors and residents. By establishing this act, number 24 of 1999, the government encouraged the BI to enhance its control of foreign exchange so that the same mistake will not be repeated.

The Act no. 24 of 1999 requires banks and NBFIs to submit a formal report based on timely and valid data. Banks and NBFIs will be sanctioned for failure to submit a report. Incorrect data and any delays in submitting the report is subject to the BI's sanction. To illustrate, when banks and NBFIs do not submit their report, they will be charged as much as Rp. 100 million and Rp. 20 million respectively.

D. SUMMARY

In order to revive the banking sector, the government has established two strategic programs: recapitalizing and restructuring the banking system, which required a huge amount of money, and also improving the existing government's regulation of the banking system.

The program of bank recapitalization and restructurization was intended to restore public confidence, especially for foreign investors. The stability of the domestic currency and transparency in the nation's payment system will encourage and invite foreign investors to conduct business in Indonesia. In turn, this will increase productivity. Promoting banking soundness is costly, and the cost is even higher to revive troubled

banks. This program of recapitalization and restructurization was viewed as the prime mover in attempting to recover from the financial crisis.

Considering that the BI as the central bank bears heavy duties, the BI needed more authority and more independence. To provide the BI with legal foundations, the government has modified the existing laws. As a result, the government issued the following: Act no. 10 of 1998; Banking System, the Act no. 23 of 1999; Bank Indonesia, and the Act no. 24 of 1999; the foreign exchange flow. The BI now is more powerful and more independent than before. The next chapter will analyze the government policies in reviving the banking sector.

V. ANALYSIS OF THE GOVERNMENT'S POLICIES IN RESPONSE TO THE FINANCIAL CRISIS

The financial crisis in Indonesia was more complex than initially thought. Multiple causes, both external and internal were overlapping and ubiquitous. These created a lot of confusion, not only for the monetary authority, but also for businesses. The result was no single solution and the need for many years to recover. The IMF and the World Bank predicted that Indonesia needed at least three years to recover, but many domestic economic experts argued that Indonesia needed more time than the IMF's prediction.

Even though the government implemented various policies to stabilize the value of the Rupiah and to calm foreign creditors, the financial crisis damaged the fundamental economy deeply. To illustrate, the numbers of non-performing loans were rising, thousands of workers were laid off, and declining imports and exports eroded the government's accountability. Moreover, many economic experts were criticizing the government because they believed some of the government's policies were inappropriate and untimely. On the other hand, the government insisted that such policies were on the right track.

In order to find out how effective the government's performance was in handling the financial crisis, analysis is needed. Two aspects of the crisis were adressed by the government.

- Government Monetary Policy
- Bank Regulation

A. ANALYZING THE MONETARY ASPECTS

The government's policies in the monetary sector focused on stabilizing the value of the domestic currency. In conducting monetary policy, the government delegated its authority to the central bank, Bank Indonesia.

During the financial crisis, the BI attempted various policies to regulate and to protect its mission and its duties. There was no doubt that some policies were really needed and suitable. But some of the policies were angering critics. Four of the BI's policies generated the most criticism:

- Imposing high interest rate
- Liquidity support program
- Dubious decision on the Exchange rate
- Establishment of the IBRA

1. Imposing High Interest Rate

In the first quarter of 1998, the BI increased the interest rate until it reached 60% per annum. After that, private banks raced to increase interest rates to attract depositors, with the assumption that they still could expand their credit to domestic investors. Bank competition to offer higher interest rates to depositors forced the JIBOR (Jakarta Interbank Overnight Rate) to increase the interest rate even higher than private banks. The interest rate at JIBOR reached its peak at 350%. (The BI's annual report 1997/1998, p.13)

On the contrary, the banks' lending declined sharply since new borrowers were reluctant to request new credit. In addition, most corporations which were using high import contents were undergoing bankruptcy because they could not afford to purchase raw materials from abroad. Moreover, most large-scale private sector companies used short-term offshore loans to fund long–term projects. When those debts matured the private sector companies were not able to pay them. As a result, banks, which had guaranteed the debts of private sector companies, were forced to make payments for companies' debts. Unfortunately, banks also were having liquidity problems since non-performing loans were rising sharply, nearly causing the banks to collapse. (The BI's annual report 1997/1998, p.14)

Imposing high interest rates to protect the domestic currency in an open economic country is highly risky. As mentioned earlier, the monetary authority was no longer able to set the supply of money single-handedly, since many factors could affect it. By changing the initial interest rate, the BI altered the previous equilibrium point to shift to a new point of equilibrium. When the BI wanted to change the level of the interest rate, the BI should have considered some related factors.

As illustrated in figure no. 1, the supply of money in circulation is fixed by the central bank and no other factors can influence it, so the supply of money curve is drawn vertically (M). The demand for money (L) is drawn downward sloping representing the negative relationship that an increase in the interest rate reduces the quantity of money demanded. According to the liquidity preference theory, if the interest rate is greater than

equilibrium level such, such as at r_1, the quantity of money people want to hold (M_1) is less than the level fixed by the central bank, and vice versa (Mankiew, 1998,p. 711).

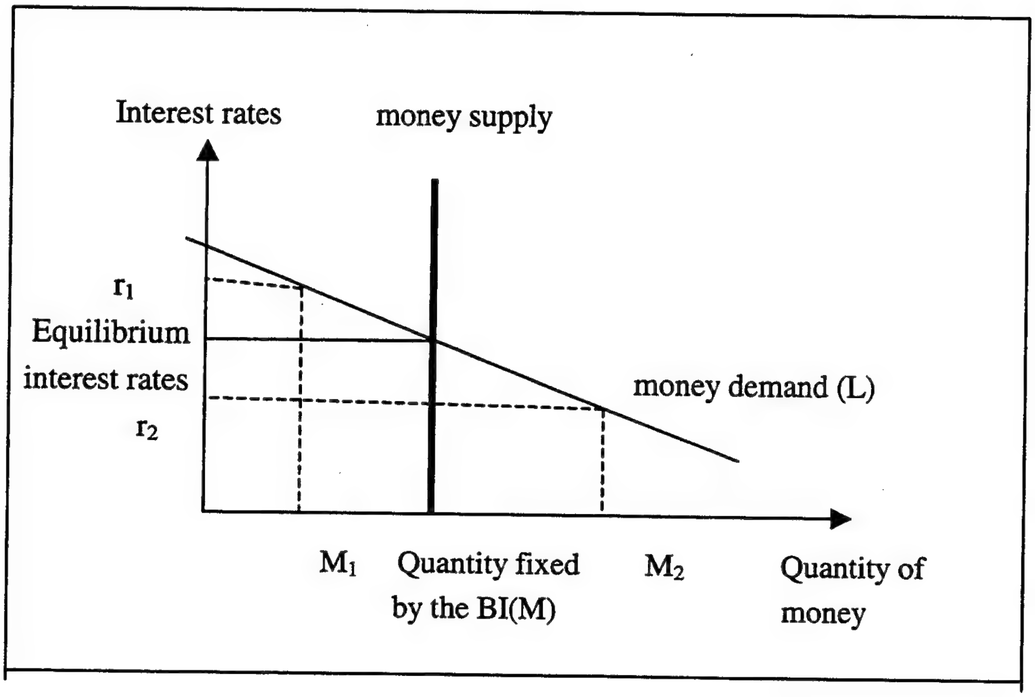

Figure no. 1. Liquidity preference (Mankiew, 1998,p. 711)

To reduce the money supply, the government increased the interest rate from the equilibrium point to the level at r_1. That meant, other things held constant, the money supply would be reduced. In turn, a speculative attack on the domestic currency could be stopped.

During the financial crisis, sixteen banks were closed and there was a rumor that the IMF was urging the government to close 42 more banks. This, of course, made people no longer want to deposit their money in banks. In addition, the Standard and Poor's downgrading of the Indonesian banks caused people to panic. Having no faith in

banks and domestic currency led people to buy foreign currency, especially the U.S. dollar. (Mann, 1998, p.52-71)

When the government increased the interest rate from r to r_1, the money supply remained unchanged at a level of M. The demand for money no longer sloped downward, instead it remained at nearly a horizontal line because people did not want to risk losing their money. (See Figure no: 2) People preferred to hold onto their money although the interest rate had increased. The theory was not wrong but the people's behavior had changed, so the outcome was totally different. It was obvious that imposing high interest rates without preserving public confidence could not help to absorb the money supply.

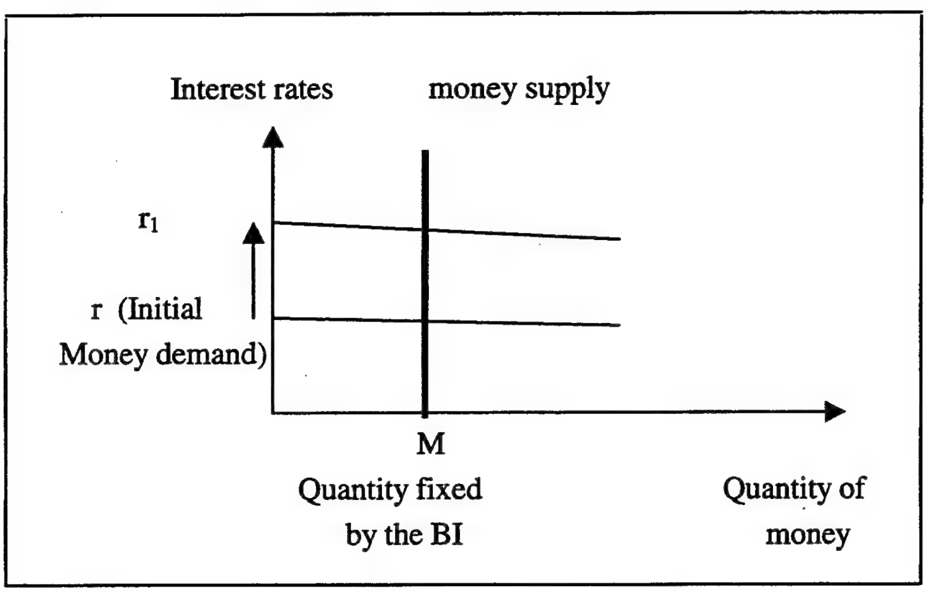

Figure No.2. Liquidity preference with inelastic money demand (Mankiew, 1998, p. 711).

Consequently, banks suffered because they had to bear a high cost on their borrowings from the central bank but were only earning a low rate of return on funds lent out to customers. Unfortunately, their lending credits dried up, since potential borrowers perceived higher interest rate as unfavorable. As a result, most banks were facing liquidity problems, even undergoing bankruptcy. The longer the government policy continued, the more banks underwent bankruptcy.

2. Liquidity Support Program

In order to survive, banks requested liquidity support from the BI. Otherwise they would collapse. Healthier banks, which previously guaranteed and funded weaker banks, were no longer able to conduct their activities unless the BI financially supported them. The BI, as the central bank, had to act as the lender of last resort and prevent banks from failure or collapse. That implies that the BI had to help banks by providing and distributing funds to them. Eventually, the BI launched a program, named "Liquidity Support of the BI" (BLBI). (Oppusunggu, 1999, p. 51)

By the end of March 1998, the total amount of BLBIs distributed to banks reached Rp. 180 trillion. This program directly increased the total amount of the money supply. In December 1997, the total supply of money was Rp. 356 trillion, growing to Rp. 566 trillion by the end of June 1998. Increasing the total supply of money reduced the value of money and increased the overall price level causing inflation. (Oppusunggu, 1999, p. 51).

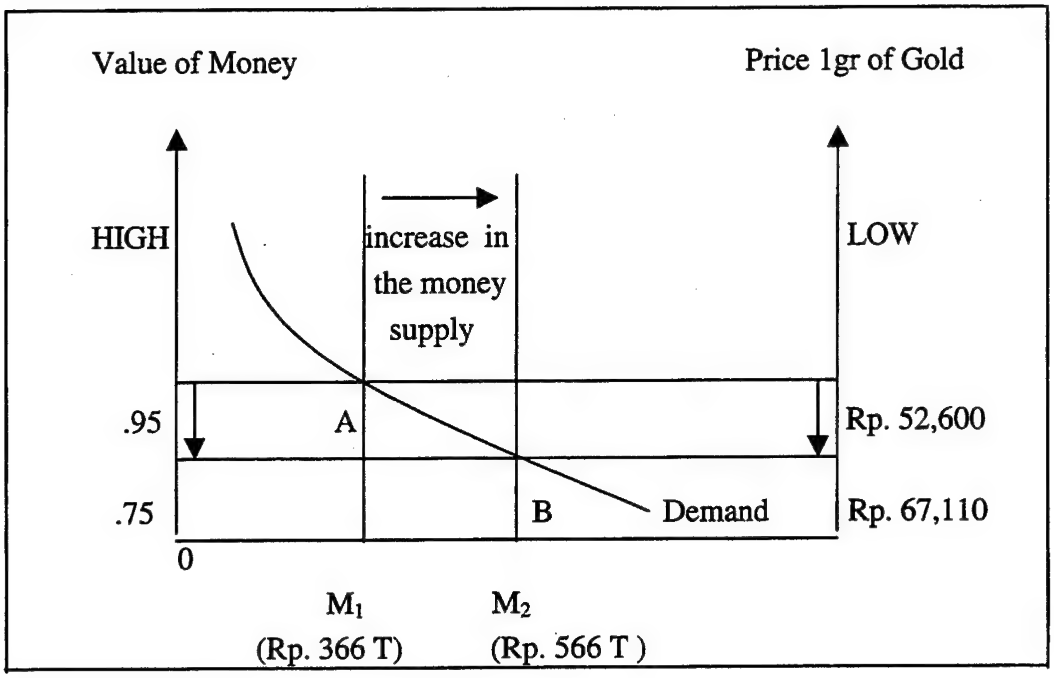

Figure no. 3. The Quantity Theory (Mankiew, 1998, p. 614)

According to the quantity theory (Mankiew, 1998, p. 614), "the quantity of money available in the economy determines the value of money, and growth in the quantity of money is the primary cause of inflation." As illustrated in figure no. 3, when the government distributed BLBIs to the banks that meant the government shifted the supply of money from M_1 to M_2. Since the demand for money remained unchanged, the equilibrium point shifted from point A (MS_1 equal to Rp. 366 trillions) to point B (MS_2 equal to Rp. 566 trillions). As a result, compared to previous years the value of money dropped from 95% at point A to 75% at point B, whereas the price of 1 gram of gold increased from Rp. 52, 600 to Rp.67, 110. This reveals the fact that inflation was rising sharply during the crisis, and apparently the BLBIs was the primary cause. In addition, the dry season was longer than normal, and this resulted in poor harvests and also caused thousands of acres of forest fires on Borneo island. The stocks of food declined in many

places and some demanded items vanished from the market. As a result, inflation was pushed even higher.

The liquidity support program was criticized because the government was seen as being inconsistent in implementing its policies. On one hand, the government enacted the tight money policy to absorb the supply of money, but on the other hand, the government increased the supply of money by distributing BLBIs. The inconsistency of managing the supply of money was because the BI was trying to reconcile external pressures. For example, ten of the largest private banks, which had a close relationship with top-level government officials, faced serious liquidity problems. Under the government influence, the governor of the BI was forced to help those banks. Later on, the liquidity support program was perceived as a failure by the new government regime. In fact, the new regime tried to legally prosecute the former president. (Infobank, June 1998)

3. Dubious Decision on the Exchange Rate

The rapid depreciation of the Rupiah in this short period, from mid 1997 with Rp. 2,400 per US dollar to Rp. 10,500 per US dollar in early 1998, concerned the government, which was challenged to halt the continuing depreciation. Historically, in 1970 the Indonesian government adopted a fixed-rate exchange system. It then moved to a crawl exchange system, which devaluated its currency at certain rates each five years, in the 1980s. In the 1990s it adopted a managed float system. Each system fit well in

certain circumstances, but none of these systems was suitable for halting the contagion effect of the Asian financial crisis. (The BI annual report 1997/1998)

The minister of Finance submitted a proposal to the House of Representatives to stabilize the value of the Rupiah against the US dollar. The proposal said that the government would rather adopt the "Currency Board Arrangement (CBA)" to halt the monetary depreciation. The pros and cons of the government proposal of CBA led to a long debate and divergent solutions. Unfortunately, the debate, which took almost a month, was broadcast on all television channels and gave the impression that the government was confused. As a result, people lost confidence not only in banks but also in the domestic currency, the Rupiah. (The BI annual report 1997/1998)

Finally, the government dropped the CBA proposal and adopted the free-float exchange rate system. The government was convinced that the CBA had weaknesses, primarily in the case of bank runs. A lender of last resort is not allowed by the CBA, meaning banks which had liquidity problems would suffer and even face bankruptcy without the central bank's help. During the financial crisis, most banks had liquidity problems. If the government enacted the CBA, clearly most banks could not survive. (The BI annual report 1997/1998)

Unlike the managed float-exchange rate, which forced the government to intervene in the market to defend the value of the Rupiah, the free-float exchange rate lets the market mechanism determine the value of currency. This meant that the government preferred to save its foreign exchange reserves for other purposes instead of defending the value of the Rupiah. Consequently, a larger depreciation would follow, causing people to

panic, especially the businesses that borrowed on offshore loans. But the dubious decision on the exchange rate system created a currency crisis not only for residents, but also for businesses. As a result, demand for the US dollars increased sharply.

4. Establishment of the IBRA

The IBRA, a temporary non-profit organization, was established by the Act no. 10 of 1998, under the command of the minister of the Finance (BPPN, 1999, p 7). Although the IBRA had a legal foundation, it raised the question of whether the task of recapitalizing and restructuring banks should be given to the BI instead of the IBRA. By establishing the IBRA, the government bore the additional cost of hiring more employees and setting up their facilities. In addition, it was very risky to entrust a huge amount of money to a new organization, such as the IBRA, which had no track record or experience. Further questions that had to be addressed included: Who were the right persons to handle this program? Would they be capable and honest in accomplishing the mission?

The government contended that, by establishing the IBRA the task of recapitalizing and restructuring banks would be accomplished successfully. In this case the government focused more on an effective approach, which meant doing what was right, rather than an efficient approach, which meant doing it right. Here are some of the reasons underlying the government's decision: 1) By establishing the IBRA, the BI could focus on monetary policy. 2) The IBRA, under the control of the minister of the finance, would assume the special task of recapitalizing and restructuring banks. In line with the establishment of the IBRA, the government also established a supervisory agency to

oversee the IBRA. 3) The government was mimicking other countries in similar situations. Most countries which experienced a financial crisis preferred to establish a new organization to revive their banks instead of using the central bank. (BPPN, 1999, p. L- 6)

The recapitalization and the restructurization-banking program obviously needed a huge amount of money. Since this program was stated in the letter of intents with the IMF, the government had no choice but to implement the program. There was no question that this program dealt with a large number of banks nationwide. This program would lead to a condition in which a large number of banks would be closed and other banks would be taken over managerially, and the rest would follow the recapitalization program. The primary question was who was supposed to bear the huge cost, the government, the bank owners, or both?

For the frozen banks which had been closed, the government was responsible to pay back the depositors and their clients. In other words, the government guaranteed the banks' liabilities. As a consequence, the government took over those banks' assets through the IBRA. The IBRA had to transfer the assets completely and was responsible for selling those assets to repay the government's funds. Understanding that the banks' liabilities were far greater that their assets, the government would bear a significant loss in the case of a bank closure. For the banks that were managerially taken over, the government occupied the banks and assisted the management to operate those banks. As a consequence, the government funded the recapitalization and restructurization program for those banks. In this case, the government faced a favorable situation compared to the

bank closure. For the banks that followed the recapitalization and restructurization program, the bank owners were required to fund as much as 20% of the total cost. (BPPN, 1999, p. L- 17)

Whatever the sources of the funds that were used for the recapitalization and restructurization program, this program absorbed enormous funds from the government's budget. According to the IBRA (1999, p. 43), "the estimated cost of the recapitalization and restructurization banking program would reach Rp. 637 trillion or 71% of the nation's GDP." The government was playing a dangerous game with the nation's economy. It seemed that the recovery of the national economy depended on the success of the IBRA in handling the program. Any obstacles which came up would slow down the recovery process.

To assess the performance of the IBRA in conducting its duties, two approaches can be used. First, examine the IBRA's ability to collect and recover the assets from the banks that had been closed and taken over. Second, evaluate the IBRA's ability to sell the assets to indigenous Indonesian businesses as top priority.

According to the IBRA, as written in the *Rencana Strategis 1999-2004*, (p. 43), "the IBRA has been collecting assets with the estimated market price of as much as Rp. 234 trillion." That meant the IBRA had collected assets equal to only 32% of the total cost of the government's funds. Lower than 50% of asset divestment is considered far below the desired standard. All the government's funds and spending must be reported to the people through the House of the Representative, but this reporting did not happen. Evidently, the government preferred to help the bank owners rather than the Indonesian

people. Also, it was obvious that the government made a responsive decision to satisfy the IMF's request rather than to protect the national interests.

By September of 1999, the IBRA had sold some assets for Rp. 612 billion, whereas the government targeted the IBRA to obtain Rp.17 trillion for fiscal year 1999-2000. Indonesian businesses were still having liquidity problems, so selling assets to them was almost impossible. Additionally, foreign investors were reluctant to purchase those assets, believing that by waiting a while longer they could buy them at a lower price. In the first quarter of 1999, The IBRA did not achieve the target for asset sales reaching only 3.6%. (BPPN, monthly report, September 1999, p. 24) Interestingly, by April 2000, the IBRA announced that it not only achieved but exceeded a target of Rp.17.1 trillion. The IBRA's strategy for achieving the government target was explained in the IBRA press release:

> This target was reached through the contribution received from all the units in the IBRA. The most important contributing factor is the sale of the Astra International shares. Following an open and fair tender process, IBRA has sold 1,019,880,060 shares in the value of Rp.3.773 trillion. The Asset Management Unit Credit (AMC) contributed Rp. 7.25 trillion. This amount comes from loan collection and the sale of asset of Bank Papan Card Center. The Asset Management Investment Unit (AMI) contributed Rp. 3.79 trillion. This contribution comes from the sale of several assets under the Shareholder Settlement program of the former shareholders of frozen banks and bank taken-over. Other proceeds come from the Bank Restructuring unit, which contributed Rp. 5.11 trillion. The agency also received proceeds in the amount of Rp. 2.77 trillion from the fee paid by banks participating in the Guarantee Program. (IBRA, press release, April 7, 2000)

This announcement showed that the IBRA's ability in asset divestment had satisfied the government standard. This ability to sell assets and repay the government's funds based on a specific target is a useful measure of performance. Failure occurred if

the IBRA was unable to achieve their target, while success occurred when it exceeded the target. The IBRA's performance was fair since it was able to satisfy the requirement.

B. ANALYZING THE FINANCIAL ASPECTS

The recapitalization and restructurization programs in the banking system conducted by the IBRA, required actions to be taken promptly and accurately. Any delays in taking correcting actions would lead to a worse condition. However, making any decisions with inadequate consideration could produce effects that might create other problems.

The IBRA and the BI agreed that all banks located and operated in Indonesia should be examined before applying for the recapitaization and restructurization program. This examination was intended to determine whether a bank should be included or excluded from the program. Banks which failed the test would be forced to merge if they were state banks or would be forced to close if they were private banks. In line with the recapitalization and restructurization programs, the government issued a program named "Banking Soundness 2002." The goal was that, by 2002, all banks which are located and operated in Indonesia would be financially and managerially healthy. (Infobank, June 1999)

Those programs for reviving the banking sector were widely supported by international financial institutions, such as the IMF, World Bank, and Asian Development Bank. This international support indicated that the government policies on the banking

system were on the right track. To analyze those policies, a closer analysis of two significant events is required:

- Capital Adequacy Ratio
- Fit & Proper Test

1. Capital Adequacy Ratio

Most developing countries which relied heavily on banks as financial intermediaries and part of the nation's payment system were reluctant to liquidate or to close banks. The worst case of liquidating or closing banks created systemic risks that threatened the nation's financial system as a whole. To illustrate, a bank failure directly impacts other healthier banks since their businesses are closely linked financially. In addition, a bank failure erodes public confidence and may provoke a generalized bank run. In turn, banks would face liquidity and solvency problems that may induce a credit crunch. The collapsed banks would damage the nation's economy as a whole. (BIS, 1999, p.36)

According to the "Competitive Theory" (Monetary and Economic Department of Basel, Switzerland, 1999, p. 36) the best way to improve efficiency and enhance productivity in industry nationwide is to allow individual firms or businesses, including banks, to fail. Allowing the weakest banks to exit the industry increases the overall efficiency. Maintaining the failing banks might cause a greater loss. If banks collapsed, all liabilities and their various debts would be the government's responsibility.

The government, through the IBRA, has actively and directly influenced the banks' condition. The IBRA employed a theory of "Capital Injection" which allowed pumping capital directly to the troubled banks. Under this theory, the IBRA categorized banks into three groups:

- Healthy banks, which were strong enough to survive without government's capital injection;

- Viable banks, which required the government's capital injection in order to survive;

- Frozen banks, unlikely to survive even with substantial government assistance.

In determining how to make a distinction between those categories, the IBRA adopted the international standards of minimum requirements of the "Capital Adequacy Ratio (CAR)." It is also called the "regulatory capital requirement," which is defined as the minimum amount of capital required to be maintained or the bank will usually require supervisory interventions. (BIS, 1999, p.1)

The capital requirement was further explained by Estrella (1995, p. 2). The capital requirement consisted of three basic components: a definition and measurement of assets, a measure of exposure to risk that capital is intended to cover, and the relationship between those two amounts. To calculate the capital regulatory requirement for a bank, first determine the total assets of the bank, consisting of core and supplemental assets. Second, calculate the total risk, consisting of risk-weighted assets plus the market risk. Last, divide total assets by risk-weighted assets plus market risk to determine the

regulatory capital requirement. In short, capital requirement can be measured by two formulas:

- $\dfrac{\text{Core Assets + Supplemental Assets}}{\text{Risk Weighted Assets + Market Risk}} \geq 8\%$

- $\dfrac{\text{Core Assets}}{\text{Risk Weighted Assets + Market Risk}} \geq 4\%$

The IBRA set the required minimum at 4% (the second equation). There was no question that the process of grouping the three categories was conducted fairly. As stated in the previous chapter, the result of this grouping of 128 private banks was that 74 passed, 37 were viable, and 17 were troubled. The IBRA closed 38 banks, which consisted of 17 troubled banks and 11 viable banks, that were unable to pay the preliminary cost of the recapitalization and restructurization programs. (BPPN, 1999, p. L- 18)

2. Fit & Proper Test

The basic reason the "fit & proper test" is vital is that the recapitalization and restructurization program involved the government's funds. The fit & proper test not only examined the financial condition of a bank, but also examined and evaluated its management, board of directors, and stakeholders. It was thought that for a funded bank to achieve the minimum requirement of 4% CAR was useless if the bank's management, board of directors or stakeholders abused or violated prudent banking practices. Therefore, the government had a right to ensure that its funds were used appropriately.

Through the Joint Decision between the Minister of Finance and governor of the BI no. 52/KMK.017/1999 and no. 31/11/KEP/GBI, the fit & proper test was formalized as a performance measurement of a bank and also as a supervisory instrument of the BI. The fit & proper test has three objectives (Infobank, June 1999):

- To examine whether or not the bank's management, board of directors and its stakeholders abused their power for their own benefits and violated prudent banking practices.
- To examine whether the bank's financial condition was healthy.
- To examine whether or not the bank's business plan was on the right track and would lead to achieving the CAR requirement by 2001.

To carry out the fit & proper test, a team was established, named the "Technical Committee," which consisted of eight personnel. The members of the team included representatives of the BI, the IBRA, and Department of the Finance. In conducting its work, the team invited a foreign consultant as its advisor. The foreign consultant was Mc Kinsey, the biggest company in management consulting in the United States. In addition, as written in the Joint Decision above, independent observers were included in the process of examining and evaluating the fit & proper test. Therefore, the fit & proper test was conducted professionally.

a. Examining & Evaluating the Bank's Management

The bank weaknesses, perceived as the core of the financial crisis in Indonesia, were due to either poor internal control or poor supervision by the BI. Most of the failed banks which were closed by the government failed caused their managers,

board of directors, and their stakeholders deliberately abused and violated prudent banking practices. As a response to this situation, the government, through the fit & proper test, would exclude bank managers who failed the test.

The "Technical Committee" set up some criteria for examination and evaluation of a bank's management (Infobank, June 1999).

a) Submitting a written commitment to the BI and the IBRA, concerning the manager's willingness to join the recapitalization and restructurization programs.

b) Whether or not their name was listed on the "Bad Managers List" or if they had resign to avoid being considered for inclusion. The BI and the IBRA set the following criteria to be listed on the bad managers list:

- Manipulated data that caused their bank to suffer.
- Made fictional transactions either on the asset side or on liability side on the bank's balance sheet.
- Colluded with the bank's clients, eroding the bank's wealth.
- Allowed internal frictions that slowed down the bank's business plan.

c) Submitted inaccurate periodic reports, by window dressing or data manipulation.

Whether or not their bank was on the list of the "non-performing loans list."

d) Whether or not the bank's management deliberately violated and abused the prudent banking practices.

e) Whether or not the bank's management ignored and violated risk management practices.

f) Examining the capability, integrity, and independence of the managers in performing their duties.

The government believed that improving the managers' skills and their accountability was critical in promoting banking soundness. Therefore, it was reasonable that the fit & proper test would be conducted annually. By August 2, 1999, the fit & proper test for all directors, commissioners, and bank owners of the 74 healthy banks (totaling around 700 people) had been completed. The result was that 194 people conditionally passed, 38 people failed the test, and the remaining passed. The 38 people, who did not pass the test consisted of 17 bank owners, 7 commissioners, and 14 directors. Those people were forced to resign. (BI, press release, 1999)

Unfortunately, the result of the fit & proper test was not widely publicized nationwide. There was no clear reason why the press did not disseminate this news. Consequently, the bank community responded negatively, especially the people who did not pass the test. Several newspapers, in an expression of bankers' dissatisfaction, highlighted allegations of unfair treatment by the BI and the IBRA. Transparency and dissemination of information had to be taken into consideration if the government wanted to restore public confidence. Critics of the government policy would slow the government programs.

b. Examining the Bank's Business Plan and Due Diligence

The examination of the bank's business plan basically focused on how to best conduct the bank's business and how to achieve the CAR requirement. If the bank's business plan would not guarantee achieving the 4% CAR requirement by 2001, that bank failed the test. In addition, if the bank's management was unable to pay 20% of the preliminary cost of the recapitalization and restructurization program to the IBRA, the bank was also considered to have failed the test. In other words, banks had to satisfy both of the requirements. A bank unable to satisfy the requirements was given a chance to be included in the recapitalization and restructurization programs, if the bank was able to pay the preliminary cost and obtain 4% of CAR within three years.

In assessing a bank's business plan, the IBRA evaluated the possibility of the bank achieving future profits. The IBRA adopted a model expressing capital change as dependent on a bank' financial state and the capital target set in the business plan. (Basle committee, 1999, p. 12) This model can be described by the equation:

$$Y(t) - Y(t\text{-}1) = \alpha\,(YD(t) - Y(t\text{-}1) + u\,(t)$$

notes: $Y(t)$ = Actual capital of a bank

$YD(t)$ = Bank's capital target at time t

$Y(t\text{-}1)$ = Actual capital of previous year

$u(t)$ = Random error

α = A positive parameter

According to this model, the growth rate of capital follows a linear function. That means this equation can predict the bank's future capital or expected capital in the next year based on the current growth of capital.

In line with the examination and evaluation of the banks'management and business plan, the IBRA also exercised "financial due diligence." Financial due diligence has many meanings; it is not a pass- fail process. It calls for judgment, not only verifying facts that have been disclosed, but also uncovering those that have not. In other words, financial due diligence is about managing risks.

The IBRA's financial due diligence process included investigating the bank's core assets, its liabilities and the responsibility of its shareholders. The first step was to investigate the frozen banks which were closed by the government. The second step focused on the viable banks, and finally the healthy banks. By April 25, 2000, the IBRA had completed the financial due diligence report for the 38 frozen banks, as reported by the IBRA:

> The IBRA has completed Financial Due Diligence reports on frozen banks. Firm legal action, commercially or criminally, would be taken against the former shareholders that would not complete negotiations with the IBRA by July. The total obligation of the 38 frozen banks was Rp. 55 trillion. The obligation arose from the BLBIs and Government Guarantee Program. The BLBIs of the frozen banks that has been cessie-ed was about Rp. 17.320.989 million, whereas Rp. 17.953.740 million in the BI's account. (Based on the Joint Decree of the Coordinating Minister of Economy, Finance, and Industry No. 12/M.EKUIN/04/2000 dated 7 April 2000, on Principles in Completing Obligations to the Government). The former shareholders have to settle their obligations in accordance with the BLBI received from or funds paid by the Government under the Government Guarantee Program on payment obligations of public banks. (Press release, April 25, 2000)

The fit and proper test, if it is implemented seriously, appropriately, and widely, should encourage and restore public confidence. But the fit and proper test alone cannot guarantee the IBRA can succeed in restoring public confidence. Law enforcement is

required to ensure that any violations, either commercial or criminal should be prosecuted.

THIS PAGE INTENTIONALLY LEFT BLANK

VI CONCLUSION AND RECOMMENDATION

A. OVERVIEW

The Indonesian financial crisis began to surface and spread nationwide in the middle of 1997, causing deterioration of the nation's fundamental economy. The Indonesian people saw that their national financial crisis resulted from the contagion effects of the Asian financial crisis. Evidently, prior to the financial crisis, most people, including both businesses and foreign investors, had limited access to information about their banks' stability. Poor supervision and inadequate law enforcement by the BI were coupled with weak internal control. These facts made it difficult for the public to determine whether a bank was in healthy or in poor condition, or even facing bankruptcy.

When neighboring countries devaluated their currencies, the Indonesian monetary authority, the BI, faced stronger pressures on the currency. Foreign investors started to dump their equity shares and abandon the region, including Indonesia. This resulted in a high demand for U.S. dollars. Concurrently, most Indonesian private sector debts, which were from offshore loans, were maturing and had to be repaid. As a consequence, massive dollar buying was intensifying the demand for the U.S. dollar, forcing the Indonesian monetary authority to devaluate the Rupiah even further.

As the Rupiah was devalued, many large-scale corporations, which imported raw materials from abroad, stopped their production because they were unable to purchase the raw materials, as prices were skyrocketing. The chain effects were severely damaging and created economic turmoil, such as high inflation and more non-performing loans. Thousands of workers were laid off, and the equity market plummeted. Unfortunately,

the supply of dollars was limited since the private sector's debts were even greater than the nation's foreign reserves. The result was tragic. The value of the Rupiah sank dramatically in a short period of time from Rp. 2,400 per a US dollar in early 1997 to Rp. 17,000 per a US dollar by the middle of 1998.

Since the economic problems were so complex and overlapping, in the early stages, the government's policies were based on situational judgment, treating the immediate symptoms, which caused other problems to arise. For example, to reduce the money supply the government imposed a high interest rate which created liquidity problems. And then, to solve the liquidity problems the government launched Liquidity support program, which created high inflation. While the government attempted to implement its policies, the government was also formulating the process of problem identification that led them to acknowledge the root of the causes. These causes could be grouped into two categories, the external causes, which were described in chapter two, and the internal causes, which were explained in chapter three.

To quell the economic turmoil, especially in the financial sector, the government enacted two major policies: recapitalization and restructurization of the banking system, and improving the legal foundation of the monetary authority by modifying the existing regulations for the banking system.

B. CONCLUSION

Analyzing the government's policies in response to the financial crisis from the monetary point of view would lead to a judgment that the monetary authority's ability to

act was affected greatly by its degree of independence from the government, which changed when a new regime came to power . In the early stages of the government efforts to overcome and to resolve the financial crisis during the old regime, the government acted as a "fire fighter," simply trying to contain the damage as soon as possible, regardless of the underlying root of the problems. Unfortunately, the monetary authority was not making good decisions, since it received a lot of pressure from many parties, including the top level of government. As a result some policies were implemented based on situational judgment, which in turn created other problems. For example, bank closures initially were intended to avoid a greater loss since these banks earned a negative profit. But when these banks were closed, the market responded negatively and the outcomes were counter-productive. People no longer had faith in banks and began withdrawing their money. This resulted in liquidity problems for the banks. Second, when the BI adopted a tight money policy by imposing high interest rates to protect the domestic currency from being attacked by speculators, this caused banks to bear a large negative spread, which created a big negative profit, and dried up their credit. Third, the Bank Indonesia Liquidity Program (BLBI) was intended to save banks from collapse due to illiquidity, but this created the problem of increasing inflation.

When the new regime rose to power, it began to improve the legal foundation of the monetary authority to make decisions by clarifying its power and duties and protecting it from external intervention or pressures. The legal foundation was stated in several acts, such as: the Act no. 10 of 1998 on Banking System; the Act no. 23 of 1999 concerning Bank Indonesia; the Act no. 24 of 1999 on Foreign Reserves Flow and Exchange Rate System.

Analyzing the government's policies from a financial point of view leads to a judgment that the government, through the IBRA and the BI, had acted correctly and appropriately. The IBRA, in the name of the government, made decisions based on an academic approach and complied with international standards. In other words, the IBRA was performing its duties professionally, for example, grouping banks into three categories based on the minimum CAR requirement. In addition, the IBRA and the BI employed a fit & proper test not only as a supervisory instrument, but also as a second filter for moving banks toward banking soundness.

Based on the analysis above, the government's policies in a response to the financial crisis were on the right track. Although accomplishment of the recapitalizing and restructuring of the banking sector was seen as a sluggish process, the IBRA asserted that by 2004 this program would be completed satisfactorily.

C. RECOMMENDATION

As mentioned in the previous chapter, there were several factors that could not be avoided by the monetary authority that slowed the speed of the process of reviving the banking sector. First, political pressures, which consisted of government intervention and political instability, obviously reduced the momentum of the process. Secondly, a lack of transparency caused people and foreign investors to lose trust in the government's accountability.

To amplify and to accelerate the recapitalizing and restructuring process, the IBRA together with the BI should have advertised the results of each step of the programs

to the public. By disseminating information to the public, it would have created a shared vision between the government and the people, in turn increasing the government's accountability. In addition, keeping the BI and the IBRA independent from external pressures would create a conducive environment for them to perform their duties optimally. Under political pressure, certainly the BI and the IBRA would fail to responsd and to make appropriate decisions.

THIS PAGE INTENTIONALLY LEFT BLANK

BIBLIOGRAPHY

Agrawal, Gokarn & Mishra & Others. *Economic Restructuring in East Asia and India.* New York, USA: Scholarly and Reference Division, ST Martin Press, 1995.

Arturo Estrella. *A Prolegomenon to future Capital Requirements.* New York: Economic Policy Review, 1995.

BPPN. *Rencana Strategis 1999 – 2004.* Jakarta, Indonesia: Badan Penyehatan Perbankan Nasional, 1999.

---. *Laporan Kegiatan Bulan September 1999.* Jakarta, Indonesia: Badan Penyehatan Perbankan Nasional, 1999.

---. *Laporan Kegiatan Bulan April,2000.* Jakarta, Indonesia: Badan Penyehatan Perbankan Nasional, 1999.

Basle Committee. *Bank Restructuring in Practice.* Basle, Switzerland: Monetary and Economic Department, 1999.

---. *Core Principles for Effective Banking Supervision.* Basle: Committee of Banking Supervisory Authorities, 1997.

Board of Governors. *Banking Policies in Indonesia.* Jakarta, Indonesia: Bank Indonesia, 1994.

Board of Governors. *The Federal Reserve System Purpose & Functions.* Washington DC: Federal Reserve System, 1994.

Camdessus. *The Challenges of a Sound Banking System.* Washington DC: the Seventh Central Banking Seminar, 1997.

Claudia & Ceyla. *Lessons from Systemic Bank Restructuring.* Washington DC: International Monetary Fund, 1997.

Cole, David & Slade Betty. *Building a Modern Financial System.* New York, USA : Cambridge University Press, 1996.

Corsetti, Pesenti & other. *What Caused the Asian Currency and Financial Crisis.* New York: 1998.

Djalil. *Seluk Beluk Pintu Seleksi.* Jakarta, Indonesia: Infobank, 1998.

Djiwandono Soedrajat. *Banking Soundness and Macroeconomic Management: The recent Indonesian Experience.* Jakarta, Indonesia: Governor of the BI, 1998.

Hadad. *Financial Market Development in Indonesia.* Jakarta, Indonesia: Senior Analyst of the BI, 1999.

Idris, Laode. *Bankir Doyan Uang Silakan Minggir.* Jakarta, Indonesia: Infobank, 1998.

Lindel & Pugel. *International Economic.* New York, USA: Irwin MC GRawl-Hill, 1996.

Mann, Richard. *Economic Crisis in Indonesia: The Full Story.* Penang, Malaysia: Gateway Books, 1998

Mankiew, Gregory. *Principles of Economics.* New York, USA: The Dreyden Press, 1998.

Nouriel Roubini. *An Introduction to Open Economy and Macroeconomics, Currency Crisis, and the Asian Crisis.* New York University: 1998.

Oppusunggu. *Sumber Krisis Moneter Indonesia.* Jakarta, Indonesia: Kepustakaan Populer Indonesia, 1998.

---. *Matinya Ekonomi Moneter.* Jakarta, Indonesia: Kepustakaan populer Gramedia, 1999.

Patricia Jackson. *Capital Requirement and Bank Behavior: The Impact of the Basle Accord.* England: Bank of England, 1999.

Pradjoto. *Logika-logika Fit and Proper Test.* Jakarta, Indonesia: Infobank, 1998.

Radelet & Sach. *The Onset of the East Asian Financial Crisis.* Cambridge, MA: Harvard Institute, 1998.

Radelet & Sach. *The East Asian Financial Crisis : Diagnosis , Remedies, Prospects.* Cambridge, MA: Harvard Institute, 1998.

Radelet & Sach. *What Have We Learned, So far, from the Asian Financial Crisis.* Cambridge, MA: Harvard Institute, 1999.

Supriyanto Budi. *Bankir Bermasalah.* Jakarta, Indonesia: Infobank, 1998.

THIS PAGE INTENTIONALLY LEFT BLANK

INITIAL DISTRIBUTION

1. DEFENSE TECHNICAL INFORMATION CENTER 2
   8725 JOHN J. KINGMAN RD., STE 0944
   FT. BELVOIR, VA 22060-62181

2. DUDLEY KNOX LIBRARY 2
   NAVAL POSTGRADUATE SCHOOL
   411 DYER RD.
   MONTEREY, CA 93943-5101

3. INDONESIAN MILITARY ATTACHE 2
   INDONESIAN EMBASSY
   2020 MASSACHUSETTS AVENUE., N. W.
   WASHINGTON D.C. 20036

4. PROFESSOR DOUG MOSSES, CODE SM/MO 1
   NAVAL POSTGRADUATE SCHOOL
   MONTEREY, CA 93943-5101

5. PROFESSOR JAMES FREMGEN, CODE SM/FM 1
   NAVAL POSTGRADUATE SCHOOL
   MONTEREY,CA 93943-5101

6. HERU SUDARMINTO 4
   KAVALERI K-100 MALANG
   JAWATIMUR, INDONESIA 25131